

## The U.S. Trade Deficit as an American Problem

*Imad Moosa and Ming Ma*

**Abstract:** For the last seven years or so the U.S. has been accusing China of manipulating its currency to keep it undervalued against the U.S. dollar. As a result, the prosecutor claims, the U.S. has been running a persistent trade deficit with China caused entirely by currency under-valuation. We argue that the U.S. trade deficit is an American problem caused by excessive spending, extremely high indebtedness, inadequate saving and the abandonment of manufacturing industry. It is demonstrated that the alleged under-valuation of the yuan is not the cause of the U.S. trade deficit with China because several real life complications prevent the materialization of the effect of the exchange rate on the trade balance.

**Keywords:** US, trade deficit, American problem, China

---

### 1. Introduction

For the last seven years or so the U.S. has been accusing China of manipulating its currency to keep it undervalued against the U.S. dollar. As a result, the prosecutor claims, the U.S. has been running a persistent trade deficit with China caused entirely by currency under-valuation. The prosecutor chooses to ignore the evidence indicating that the Chinese currency is not undervalued, particularly that the yuan has appreciated considerably since 2005. The prosecutor also rejects the argument that China has the right to choose a fixed exchange rate regime, which requires market intervention (hence the so-called “manipulation”).<sup>1</sup> Ideology, it seems, has replaced rational economic thinking just to show that China is responsible (among other things) for the massive U.S. trade deficit, which is a serious problem of America’s own making. The culture of blaming own problems on others seems to be as rife as ever—it was demonstrated vividly by Mitt Romney during the 2012 presidential race.

Blaming China for America’s economic woes has a popular and populist appeal. For example, Gilbert (2012) argues that “with the country’s manufacturing base suffering, there is a swathe of US voters looking for someone to blame for the unsettling situation”. The fact of the matter is that America has only itself to blame for its trade deficit. Like households, countries run trade deficits if they consume more than what they produce. The situation becomes even worse if excessive spending is financed by borrowing, particularly borrowing from foreigners. A meat lover cannot logically blame his butcher for the trade deficit he has with the butcher. For this person to eliminate the deficit, he must take the brave decision to become a vegetarian—otherwise he should stop complaining about the deficit and finance it somehow.

---

<sup>1</sup> The revised Article IV of the IMF charter gives member countries the right to choose any exchange rate regime it deems suitable for its economy. For a detailed discussion see Moosa (2012b).

In this paper we demonstrate why the U.S. trade deficit is an American problem caused by excessive spending, extremely high indebtedness, inadequate saving rate and economic structural changes away from manufacturing industry. Before we do that, we start by illustrating why it is that the exchange rate between the U.S. dollar and the yuan has nothing to do with the U.S. trade deficit with China.

## 2. The trade balance-exchange rate nexus

There is a heated debate about whether or not revaluation of the yuan will work, in the sense that it eliminates or at least reduces the U.S. trade deficit with China. For example, a Nobel Prize winner, Joseph Stiglitz, thinks that revaluation will not work but another Nobel Prize winner, Paul Krugman, says that it will. Robert Mundell, a Nobel Prize winner himself, agrees with Stiglitz by arguing that “there’s no evidence that exchange rates correspond with trade balances” and that “the U.S. arguments in this regard are intellectually weak” (Dukes, 2005).

Fatas (2010) casts a big shadow of doubt on Krugman’s argument that trade imbalances cannot be corrected without changing the exchange rate, as he (Krugman) “almost implies that current account imbalances are always the result of exchange rate misalignments”, which is such an extreme position. Fatas argues that while the current account (hence the trade balance) may react to changes in the exchange rate, changes in saving and investment (which impinge on the current account) are driven by many other factors.

Krugman’s argument is that an increase in Chinese consumption will not reduce China’s current account surplus unless this consumption translates into imports, and for this to happen “we need a relative price change” (triggered by changes in the exchange rate).<sup>2</sup> Fatas puts forward the view that “the Chinese will have to get used to consume more, Americans will need to understand that they need to save more and this will be the main factor that will drive the current account adjustment”. Although this argument does not put the blame totally on China, asking or telling the Chinese to consume more (and save less) does not sound right—it is not that the Chinese do not consume. What is obvious is that a brilliant international economist, Krugman, has chosen (for not-so-obvious reasons) to forget about economic theory, empirical evidence, stylized facts and simple intuition so as to take part in a witch-hunt against China. Franks (2010) says the following in response to Krugman’s argument:

Economic textbooks say that if a currency rises, its exports become more expensive to customers in other countries, while a weaker currency makes exports less expensive. In a vacuum that makes sense, but reality shows that this simplified concept is false.

The naïve view is that the trade balance improves following domestic currency depreciation because imports become relatively more expensive, leading to a reduction in the purchase of foreign goods (imports), while exports become more attractive for foreigners as they are relatively cheaper. This view, however, overlooks all of the conditions required for this process to work smoothly and the changes in other factors that may sabotage it. Goldberg and Tille (2006) put it succinctly as follows:

---

<sup>2</sup> Krugman chooses to overlook the fact that the U.S. has nothing much to export to China. Manufacturing industry of consumer goods is all but dead while restrictions are imposed on the exports of high-tech goods.

A number of things must happen before exchange rate changes lead to trade balance adjustments. First, the exchange rate change must lead to changes in the border prices of goods imported by the destination market. Next, the change in border prices must lead to a change in the price of goods charged to consumers. Finally, the consumer must react to the relative price of import goods, substituting away from imports if they have become more expensive, or increasing demand for imports if they have become relatively cheap. If the exporters adjust their own profit margins to insulate foreign prices from exchange rate fluctuations, nominal trade balance implications arise purely due to revenue effects of exchange rates on existing quantities of goods traded.

Goldberg and Tille, therefore, refer to the complications and conditions that impede the working of exchange rate adjustment.

But there are more factors that can cause a breakdown of the of the trade balance-exchange rate nexus than what appears on the Goldberg-Tille list. Moosa (2012a) identifies real-life complications that hamper the adjustment process. Among these complications are factors that prevent the materialization of a full pass-through effect from the exchange rate to the prices of imports and exports. These factors include the presence of local currency mark-ups and profit margins and the use by the Chinese of the dollar as the currency of invoicing. There is also the problem that the U.S. no longer produces the low-tech, labour-intensive goods that can compete with Chinese exports.

Let us examine the facts and figures on the relation between the U.S. trade deficit with China and the yuan/dollar exchange rate. China bashers suggest that as the exchange rate declines (the yuan appreciates), the trade deficit should shrink. But this kind of effect is not to be seen in the data. Figure 1 shows monthly data on the U.S. deficit and the exchange rate for the period January 2004-August 2012. While the monthly deficit figures are conspicuously seasonal, the long-term trend is for a widening trade gap. This has happened despite the fact that the yuan has appreciated in nominal terms by 22 per cent since the June 2005 change in exchange rate policy.<sup>3</sup> In Figure 2 we show annual statistics where deterioration in the U.S. trade balance is associated with appreciating yuan. What seems to be an improvement in 2012 is due not to the exchange rate but rather to recessionary conditions in the U.S., a phenomenon that was observed in 2009. Figure 3 is a scatter diagram of moving average indices of the exchange rate deficit. They seem to be positively, not negatively, correlated. And in Figure 4 we exclude the points where the exchange rate was fixed, which makes the positive association crystal clear. There is no evidence whatsoever, in this data set at least, to indicate that revaluation of the yuan will work. It has not worked so far, and there is no reason why it would work in the future.

### **3. Fiscal profligacy as a cause of the trade deficit**

Fiscal profligacy means extravagant and wasteful spending—living beyond one’s means and sustaining this kind of lifestyle by borrowing from others. Peter Morici, University of Maryland professor and former chief economist in the U.S. International Trade Commission, is quoted as saying explicitly that “the trade

---

<sup>3</sup> On 29 October 2012 the yuan reached its highest level against the dollar in nearly 19 years, hitting an intraday high of 6.2371. The appreciation of the yuan in real terms has been more spectacular. According to The Economist (2010a), the Chinese currency has appreciated by about 50% since the 2005 exchange rate policy change.

deficit indicates Americans live beyond their means” and that “they’re not producing the goods they wish to use” (Business Today, 2011). Excessive spending and inadequate saving by both the private and public sectors necessarily imply a trade deficit—it does not need an economist to figure that out.

The proposition that the U.S. trade deficit is an American problem caused by fiscal profligacy is easy to rationalize. If I spend more than what I earn and finance my spending by borrowing, I will have negative saving and a trade deficit, a self-inflicted problem of mine. Likewise the U.S. trade deficit is an American problem that only America can deal with. Johnson and Kwak (2009) make this point in a sarcastic manner by suggesting that “it takes two to tango” and that “no one put a gun to the American consumer’s head and forced them to buy a new flat-screen TV or to do so by taking out more debt”.

The Congressional Budget Office identifies “three major changes in the U.S. trade deficit since 1970” (CBO, 2000). These changes can be traced to three primary sources: “a long decline in saving as a share of gross domestic product (GDP) that began in the mid-1950s and accelerated in the 1980s, fluctuations in the business cycle, and relatively attractive investment opportunities in the United States in the 1990s”. The CBO attributes the trade balance not to international trade but to “factors affecting international capital flows”, which are “largely of domestic origin—a long decline in saving, a prolonged upswing in the business cycle, and perhaps a number of changes in the U.S. economy that have made it a particularly productive place for international investors to put their funds”. As a result the U.S. has become a “habitual borrower”, a term that is used by Liu (2005b) to describe “a trading partner that runs a recurring trade deficit”.

Those claiming that the trade deficit is caused by the exchange rate base their argument on the functional relation  $B = f(E)$  where  $B$  is the trade balance and  $E$  is the exchange rate. The problem is that this functional relation is misspecified because in reality it is  $B = f(E, X_1, X_2, \dots, X_n)$  where  $X_1, X_2, \dots, X_n$  are other determinants of the trade balance. Changes in these factors are likely to offset changes in the exchange rate—that is if the exchange rate has any effect whatsoever. This is why there is no precise relation between the exchange rate and the trade balance, and this is why the empirical evidence does not support the proposition of a predictable effect from the exchange rate to the trade balance. On the other hand, it is rather intuitive to argue that the trade deficit is the result of fiscal profligacy. The macroeconomic identity, which holds as an accounting relation under all circumstances, tells us that  $I + G + M = S + T + X$  where  $I$  is investment (capital formation),  $G$  is government spending,  $M$  is imports,  $S$  is saving,  $T$  is tax revenue and  $X$  is exports. By manipulating this identity we obtain the relation  $X - M = B = (I - S) + (G - T)$ . The trade deficit is accounted for by the budget deficit,  $(G - T)$ , and low saving relative to investment,  $(I - S)$ . This is an accounting identity that requires no empirical evidence—it explains precisely why the U.S. trade balance is an American problem caused by fiscal profligacy.

#### 4. Excessive public debt

The U.S. public debt is a measure of the obligations of the U.S. government as represented by the Treasury. It consists of two components: (i) the outstanding Treasury securities held by institutions and individuals outside the U.S. government, and (ii) inter-governmental holdings representing the obligations

of the federal government for specified programmes such as social security and Medicare. Between 2005 and 2008 public debt increased at an average rate of \$2.27 billion per day, only to grow faster in the aftermath of the global financial crisis because of the bailout of failing financial institutions. The most recent figures show that it stands at over \$16 trillion, putting the debt to GDP ratio at over 100 per cent.<sup>4</sup>

The CBO (2010) attributes the rapid growth of U.S. public debt in recent years to the budget deficits preceding the great recession and the global financial crisis, warning that the ratio of public debt to GDP will rise if “current policies remain in place”. For some observers what is even more alarming is that an increasing portion of U.S. public debt is held by foreigners. Friedman (2008) argues that increasing dependence on foreign sources of funding will render the U.S. less able to act independently. He quotes the old saying “he who has the gold makes the rules” and suggests that “we [the U.S.] no longer have as much gold, and until we get some, we will have to pay more heed to the rules of those who lend us theirs”. Buffett (2003) argues that foreign ownership of public debt is no less than the transfer of the country’s net worth to foreigners. Unlike domestic debt holders, foreign lenders are concerned about the exchange rate factor, which makes the U.S. more vulnerable to the sentiment of foreign providers of credit. Stockman (2010) argues that “the U.S. public debt— if honestly reckoned to include municipal bonds and the \$7 trillion of new deficits baked into the cake through 2015 — will soon reach \$18 trillion”, which is “a Greece-scale 120 per cent of gross domestic product, and fairly screams out for austerity and sacrifice”. The U.S. is even more vulnerable now that concern is being repeatedly expressed about the privileged status of the dollar in the International Monetary System.

Kotlikoff (2006) argues that the extent of the dire fiscal situation in the U.S. is not measured by the public debt to GDP ratio but in terms of the fiscal gap. In 2006, David Walker, the then head of the Government Accountability Office (an arm of Congress that audits and evaluates the performance of the U.S. government), warned that “if the United States government conducts its business as usual over the next few decades, a national debt that is already \$8.5 trillion could reach \$46 trillion or more, adjusted for inflation. He added that “a hole that big could paralyze the U.S. economy..., just the interest payments on debt that big would be as much as all the taxes the government collects today” (CBS News, 2006). Penner (2010) argues that “the budget deficit is on a ruinous path and getting off the path involves far more significant policy changes than the American people are used to”. The situation is indeed alarming.

Debt causes and is caused by the accumulation of fiscal deficits. More debt means more interest payments and a growing deficit. Conversely bigger deficits need more borrowing to finance them. We have also seen how the budget deficit is associated with the trade deficit. In the following section we discuss the seriousness and causes of the U.S. budget deficit.

### **5. The U.S. budget deficit**

The U.S. budget deficit, standing at \$900 billion in 2013, can be attributed to both the revenue and spending sides of public finance. The Congressional Budget Office warns that “unless policymakers restrain the growth of spending, increase revenues significantly as a share of GDP, or adopt some

---

<sup>4</sup> See, for example, <http://www.usgovernmentdebt.us/>.

combination of those two approaches, growing budget deficits will cause debt to rise to unsupportable levels” (CBO, 2010).

A major reason for running budget deficits is massive military spending, which has been the subject of a heated debate. Hartung (2007) criticized the military spending spree of George Bush II, arguing that it “comes at a time when America’s main enemy is not a rival superpower like the Soviet Union, but a network of terrorist groups armed primarily with explosives, shoulder-fired missiles, and AK-47s”. Hossein-Zadeh (2007) describes the George Bush II administration’s escalation of war and military spending as a “boon for Pentagon contractors”, arguing that these profiteers of war and militarism have also played a critical role in creating the necessary conditions for war profiteering—that is, “instigating the escalation of the recent wars of choice and the concomitant boom of military spending”.

Despite the fact that U.S. military spending is enormous in both absolute terms and in relation to total spending and GDP, Higgs (2004) believes that the military budget is bigger than what it appears to be. He argues that this enormous amount is “only part of the total bill for defense”. Specifically he argues that “other lines identify funding that serves defense purposes just as surely as—sometimes even more surely than—the money allocated to the Department of Defense”. These items, according to Higgs, include the nuclear weapons activities of the Department of Energy and more or less all of the activities of the Department of Homeland Security (DHS). Higgs concludes that if we take into account the complexity of the budget document (hence the omitted items) “a well-founded rule of thumb is to take the Pentagon’s (always well publicized) basic budget total and double it”. You “may overstate the truth”, he argues, “but if so, you’ll not do so by much”.

Liu (2005a) makes a very interesting comment whereby he relates the military budget to the trade deficit. By referring to the 2004 figures, when the trade deficit and the budget deficit were about 6 and 4 per cent of GDP respectively, he argues that “the trading partners of the U.S. are paying for one and a half times of the cost of a military that can someday be used against any one of them for any number of reasons, including trade disputes”. This follows from the ability of the U.S. to print dollars and use them to buy goods and services under the umbrella of dollar hegemony. Incidentally, Liu believes that “the dollar is a fiat currency not backed by gold, not backed by U.S. productivity, not backed by U.S. export prowess, but by U.S. military power”.

The U.S. budget deficit has been recognized as a major problem that threatens the long-term prospects of the U.S. economy. In a June 2010 opinion piece in the *Wall Street Journal*, the former chairman of the Federal Reserve, Alan Greenspan, noted that “only politically toxic cuts or rationing of medical care, a marked rise in the eligible age for health and retirement benefits, or significant inflation, can close the deficit” (Greenspan, 2010). He warned that “if significant reforms are not undertaken, benefits under entitlement programs will exceed government income by over \$40 trillion over the next 75 years”. Kotlikoff (2006) argues that the U.S. “must eventually choose between bankruptcy, raising taxes, or cutting payouts”, which means that he overlooks the other option of restoring to the printing press to create fresh money. In general he points out that “countries can go broke, the United States is going broke, that remaining open to foreign investment can help stave off bankruptcy, but that radical reform of U.S. fiscal institutions is essential to secure the nation’s economic future”.

## The U.S. Trade Deficit as an American Problem

Warnings about the prospects of an uncontrollable budget deficit and the consequences for public debt have become quite common. For example, a report of the Peter Peterson Foundation (2010) states the following:

The U.S. faces a looming fiscal crisis. With escalating deficits, mounting levels of public debt, growing unfunded promises for large individual, entitlement programs, and increasing reliance on foreign lenders, we as U.S. citizens should be very concerned about the deteriorating financial conditions of our nation.

The problem with the U.S. deficit is that it is not just a passing phenomenon—rather it is a structural long-term problem created by addiction to excessive spending and the belief that tax cuts pay for themselves. The Peter Peterson Foundation (2010) describes the situation as follows:

The deficits for fiscal years 2009 and 2010 are largely attributable to significant declines in revenue due to a recession and weak economy, the cost of the wars in Iraq and Afghanistan, and various government bailouts and stimulus actions. These items do not represent long-term and recurring fiscal challenges. However, even after the economy recovers, the special federal interventions are complete, the wars are over, and unemployment levels are down, deficits and debt are expected to grow at a rapid rate. As a result, the U.S. will find itself in an unsustainable fiscal position in the years to come. If current policies are left unchanged, debt held by the public is projected to spike even further, reaching over 300 percent of GDP in 2040.

According to the Peter Peterson Foundation (2010), a big threat comes from interest payments, which are projected to be “the largest single line item in the federal budget—larger than defense, Medicare or Social Security”. It is estimated that by 2040, assuming that the U.S. does not have to pay a risk premium, federal interest costs will account for 14 per cent of the entire U.S. economy. If interest rates rise just two percentage points, interest costs alone could represent about 20 per cent of the economy by 2040. The estimates show that by 2024, historical revenue levels of about 18 per cent of GDP will not cover interest payments, social security, Medicare and Medicaid. This means the government will need to borrow to pay for other essential programmes such as education, transport and everything else that keeps the economy going. The dismal conclusion of the report of the Peter Peterson Foundation is that:

If we continue down this path, rising deficit and debt levels will impact our everyday lives by threatening our nation’s economic strength (lower investment and growth), our international status (weaker standing in the world and international capital markets), our standard of living (higher interest rates for loans and mortgages, higher unemployment rates, lower wages), and possibly our national security (higher dependency on foreign governments that purchase U.S. debt). Moreover, higher debt levels mean more resources devoted to compounding interest payments on the debt, which increasingly go abroad rather than stay in this country. Thus, we have fewer resources available for domestic investment in research and development, education, infrastructure and other crucial investments that maintain our economic competitiveness.

Yet nothing is being done about the problem. Samuelson (2009) argues that “the president does not want to confront Americans with choices between lower spending and higher taxes”. But now that the president is back in the White House with no chance for a third term, he may decide to go for both. His problem is to convince the Republican law makers that the deficit is both a revenue and a spending problem.

The Economist (2010b) makes the comparison between Europe and the U.S., by commenting on a report of the IMF declaring that “America’s structural deficit and the growth in debt over the medium term are among the worst in the rich world”. For example, Germany has passed a balanced budget constitutional amendment, the U.K. has launched a four-year plan to deal with the deficit and France has raised the pension age. The U.S., on the other hand, has no taste for austerity, which is justified by saying that the economy is not in a good shape for taxes to be raised. It is, however, ideology rather than macroeconomic conditions that motivate U.S. distaste for austerity.

The current debate is about whether the budget deficit represents a spending problem, a revenue problem or both. The Republicans think that it is a spending problem, thus they oppose any tax increases (some of them even advocate tax cuts). Republican Congressman and Speaker of the House, John Boehner, believes that “Washington has a spending problem, not a revenue problem” (Boehner, 2011). These remarks were made at a press conference with Republican leaders on 13 April 2011 in which Boehner declared:

The American people know that we can’t continue to spend money we don’t have. And I think the American people also understand that this hurts our economy and hurts job creation in our country... You are also aware I have been pushing the president for months to engage in this discussion about our long-term fiscal mess. And I’ll just say this: we can’t tax the very people that we expect to reinvest in our economy and to create jobs. Washington has a spending problem, not a revenue problem.

Variations on this statement have been made by other Republicans, such as House Majority Leader Eric Cantor, who suggested that “most people understand that Washington doesn’t have a revenue problem, it has a spending problem”, emphasizing that “we can’t raise taxes” (Cantor, 2011). In the 2012 presidential race, Mitt Romney insisted on reducing the deficit while reducing taxes—something that does not add up, except for the proposition that tax cuts are self-financing. However, there is not a shred of evidence to support this proposition (see, for example, Moosa 2012b).

With a mentality like this, it is doubtful if America’s fiscal mess is going to be sorted out any time soon. The Bank for International Settlements warns that “failure to do so will raise the chance of an unexpected and abrupt rise in government bond yields at medium and long maturities, which would put the nascent economic recovery at risk” (Cecchetti et al, 2010). Likewise, Walker (2008) makes it clear that “the sooner we started, the better”.

## **6. Private saving, consumption and debt**

The U.S. trade deficit is an American problem because it is the result of too little saving and too much consumption financed by too much debt. The Congressional Budget Office makes this point quite clear by

suggesting that “the U.S. current account deficits of the past two decades were brought on primarily by a long downward trend in domestic saving as a percentage of GDP that began in the mid-1950s and accelerated in the early 1980s” (CBO, 2000). Likewise Kotlikoff (2008) argues that “the decline of the saving rate explains, in large part, why the United States has run a very large current account deficit in recent years”.

The current situation in the U.S. has materialized as follows. The decline in the saving rate led to a shortage of funds available for domestic investment, which caused interest rates to rise, attracting capital flows from abroad. As saving declined, consumption increased—this is because saving means consuming less out of current income in the present in order to consume more in the future. Therefore the decision to save now is equivalent to the decision to defer consumption and to store it in the form of an asset. The problems associated with a low saving rate include dependence on foreigners and retrenchment risk in consumer spending. If the saving rate falls too low to be consistent with sound long-run plans, a sudden correction of consumption habits may translate into a substantial reduction in consumption expenditure and therefore aggregate demand. Moreover, saving is important for capital formation and economic growth.

In June 2005, *The Christian Science Monitor* reported that “Americans have stopped saving for a rainy day” and that “they are living paycheck to paycheck, depending on credit cards to get them through emergencies, and hoping that the rising value of their homes will give them a retirement nest egg” (Marks and Scherer, 2005). The article warned that “the nation’s paucity of savings is raising alarms from the Federal Reserve to consumer watchdogs, who worry that the nation is counting on foreign savings to maintain a spendthrift lifestyle”. It is even suggested that the tax system needs to be changed to encourage saving instead of spending. Nancy Register, of the Consumer Federation of America, is quoted as saying that “in two generations it seems that we’ve lost the culture and habit of savings” and that “there’s so much marketing pressure to spend and buy and have instant gratification”.

Likewise, the Federal Reserve’s former chairman, Alan Greenspan, is quoted as warning that “the low savings rate is impairing the nation’s long-term economic prospects” and that “an improved savings rate would provide investment money for businesses, which would create jobs” (Marks and Scherer, 2005). It is strange, therefore, that Bergsten (2010) makes it sound as if Americans consume excessively because of altruism towards the rest of the world when he argues that “the United States must convince the world that it is unwilling again to become the consumer and borrower of the last resort”. This view is rather ludicrous and not worthy of any comment. A more credible view is expressed by Persaud (2010) who refers to a “consumption binge in the U.S., evidenced by a negative personal saving rate, excessive leverage, historically high unemployment levels and record international deficits”.

## **7. The demise of manufacturing industry**

An important reason why the U.S. trade deficit is an American problem is that the U.S. no longer produces the manufactured goods imported from China due to the erosion of the industrial base, which free-marketeers consider to be “natural”, a phase of economic evolution. These pundits believe that while this change may hurt workers in the doomed sectors, they will over time find more rewarding jobs and benefit

from cheap, high-quality imports (Friedman, 2002). Liu (2005c) quotes Alan Greenspan as saying, in a testimony to Congress, that “thinking jobs are better than doing jobs” and that “the U.S. will keep higher-paying jobs in financial services, management, design, development, sales and distribution and let the emerging economies have the low-paying assembly line jobs in factories owned by U.S. companies”. If this process is natural and cheap high-quality imports are desirable, why then is China blamed for producing cheap high-quality imports? Liu (2005b) attributes the erosion of the U.S. manufacturing base to “neo-liberal global trade in the last two decades”, motivated by dollar hegemony: print dollars and buy the stuff rather than toiling to make it.

Friedman (2002) disagrees with the proposition that it is natural for services to replace manufacturing industry by arguing along the following lines:

Such beliefs were plausible in 1994-1998, when business-service employment was booming. As millions of jobs in technically demanding work--programming computers, setting up communications systems, for example--were created, business services offset slower growth or job losses in manufacturing. But when manufacturing went into a tailspin in the later 1990s, the business-service growth that powered the healthiest phases of the decade's boom slowed too. Rather than supplant manufacturing, business-service enterprises depended on healthy factories, which, after all, were among their biggest clients.

Friedman is justifiably sarcastic when he points out that “it's hard to imagine how service-sector expansion can play a role in wealth creation if growth in, say, manicurists exceeds that of engineers”. And while manufacturing industry lends itself to specialization and economies of scale (hence, rising productivity) the service industry kills productivity because there is no potential for the exploitation of economies of scale and exports.

Some pundits attribute the decline of manufacturing employment in the U.S. to Chinese policies. For example, Scott (2008) argues that “the growing U.S. trade deficit with China has displaced huge numbers of jobs in the United States and has been a prime contributor to the crisis in manufacturing employment”. On the one hand, the shift from manufacturing industry to services is a natural phase in the process of economic evolution. On the other hand, the demise of manufacturing industry, which is allegedly caused by China, is regrettable and a blow to the ability of the U.S. economy to create jobs. What are we supposed to believe?

The decline of manufacturing industry in the U.S., and elsewhere where the American model is cherished, is a consequence of the illusion that as countries mature they shift from manufacturing to services. Financial services, in particular, are thought by some to be an appropriate replacement for manufacturing industry as the backbone of the economy. In the U.K., for example, policy makers have been guided (or rather misguided) by the motto “who needs manufacturing industry when we have the City?”. It is this kind of thinking that provides the justification for abandoning manufacturing industry. The reality is that a modern economy cannot be run on a sector that is dominated by parasitic activities, which is exactly what the modern financial sector is all about.

The U.S. economy has changed from a super manufacturing power to one dominated by the financial sector. While the Chinese have been making consumer goods and machine tools, the Americans have been making financial products that have no social value whatsoever and can be destructive as demonstrated by the global financial crisis. While the Chinese have been promoting the products of scientific innovation and engineering, the Americans have been promoting the products of financial engineering: options on futures, futures on options, options on futures on options on swaps, CDOs, CDSs, and so on. Any wonder then why the U.S. has a trade deficit with China?

## **8. Concluding remarks**

It is just as well that Mitt Romney lost the presidential election to Barack Obama because tension with China would have been greater under Romney who threatened to call China a “currency manipulator” on his first day in office. During his election campaign, Romney pointed his finger squarely at the “weakness” of the Chinese currency, indicating that, as a president, he would enact tariffs against any country that is “unfairly taking advantage of US manufacturers” (whatever is left of them)—meaning, of course, China. Had he won, he would have almost certainly signed into law a bill passed by the Senate in October 2012 allowing the U.S. government to levy tariffs on countries with “undervalued” currencies—meaning, of course, China. That would have been a declaration of a trade war. Romney also promised to boost military spending and cut taxes, meaning a growing budget deficit and hence a trade deficit that would have been blamed on China.

It is not that Barack Obama has not played the blame game against China. He has repeatedly called on China to “revalue its currency” in the same manner as any right-wing hawk. But now that Obama is in his second term in office, we hope that he will be more reconciliatory and more realistic in dealing with China. Realism starts by admitting that the U.S. trade deficit with China is an American problem that only America can and should deal with. Let us at least hope that he will be wise enough not to sign into law the anti-Chinese bill passed by the Senate in October 2012.

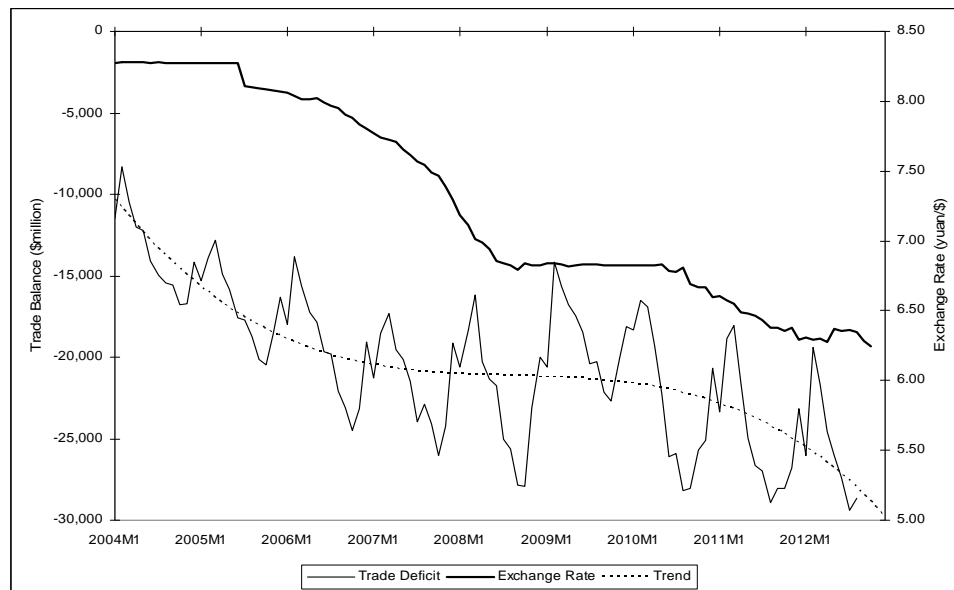
## References

- Bergsten, C.F. (2010) New Imbalances will Threaten Global Recovery, *Financial Times*, 10 June.
- Boehner, J. (2011) Washington Has a Spending Problem That Hurts Job Creation, Not a Revenue Problem, 13 April. <http://johnboehner.house.gov/News/DocumentSingle.aspx?DocumentID=236233>.
- Buffett, W. (2003) America's Growing Trade Deficit is Selling the Nation, *Fortune*, 10 November. <http://www.independent.ie/business/world/buffett-trade-deficit-could-pell-turmoil-118449.html>.
- Business Today (2011) US Trade Deficit Broadens Sharply. <http://www.businesstoday-eg.com/economy-policies/united-states/us-trade-deficit-broadens-sharply.html>.
- Cantor, E. (2011) Spending, Not Revenue, is the Problem, 24 February. <http://www.cbsnews.com/stories/2011/04/13/earlyshow/main20053445.shtml>.
- CBO (2000) Causes and Consequences of the Trade Deficit: An Overview. <http://www.cbo.gov/doc.cfm?index=1897&type=0>.
- CBO (2010) Federal Debt and the Risk of a Fiscal Crisis, *Economic and Budget Issues in Brief*, 27 July.
- CBS News (2006) America the Bankrupt: GAO Head Takes Fiscal Show on the Road to Warn of Trouble Ahead, 28 October.
- Cecchetti, S.G., Mohanty, M.S. and Zampolli, F. (2010) The Future of Public Debt: Prospects and Implications, BIS Working Papers, No 300, 26 March.
- Dukes, C.J. (2005) Nobel Laureates Back RMB's Dollar Peg, 15 June. <http://www.btmbeijing.com/contents/en/bbonline/2005/articles/nobel>.
- Fatas, A. (2010) Current Account Imbalances and Exchange Rates, 7 April. <http://fatasmihov.blogspot.com/2010/04/current-account-imbances-and-exchange.html>.
- Franks, J. (2010) Failed Interventions and Export Prices, *Seeking Alpha*, 12 September. <http://seekingalpha.com/article/224745-failed-interventions-and-export-prices?source=feed>.
- Friedman, D. (2002) No Light at the End of the Tunnel. [http://www.newamerica.net/publications/articles/2002/no\\_light\\_at\\_the\\_end\\_of\\_the\\_tunnel](http://www.newamerica.net/publications/articles/2002/no_light_at_the_end_of_the_tunnel).
- Friedman, T. (2008) Swedish Spoken Here, *New York Times*, 4 October.
- Gilbert, N. (2012) A Romney Victory Could Heighten China Tensions, 23 October. <http://www.cityam.com/wealth-management/romney-victory-could-heighten-china-tensions>.
- Goldberg, L. and Tille, C. (2006) International Role of the Dollar and Trade Balance Adjustment, Occasional Paper 71, Group of Thirty, Washington DC.
- Greenspan, A. (2010) The U.S. Debt and the Greece Analogy, *Wall Street Journal*, 18 June.
- Hartung, W.D. (2007) Bush Military Budget Highest Since WWII, 10 February. <http://www.commondreams.org/views07/0210-26.htm>.
- Higgs, R. (2004) The Defense Budget is Bigger than You Think, 25 January. [www.Antiwar.com](http://www.Antiwar.com).
- Hosseini-Zadeh, I. (2007) Escalating Military Spending—Income Redistribution in Disguise. <http://www.informationclearinghouse.info/article17552.htm>.
- Johnson, S. and Kwak, J. (2009) Don't Blame China, *Washington Post*, 6 October.
- Kotlikoff, L.J. (2006) Is the United States Bankrupt?, *Federal Reserve Bank of St. Louis Review*, July/August, 235-249.

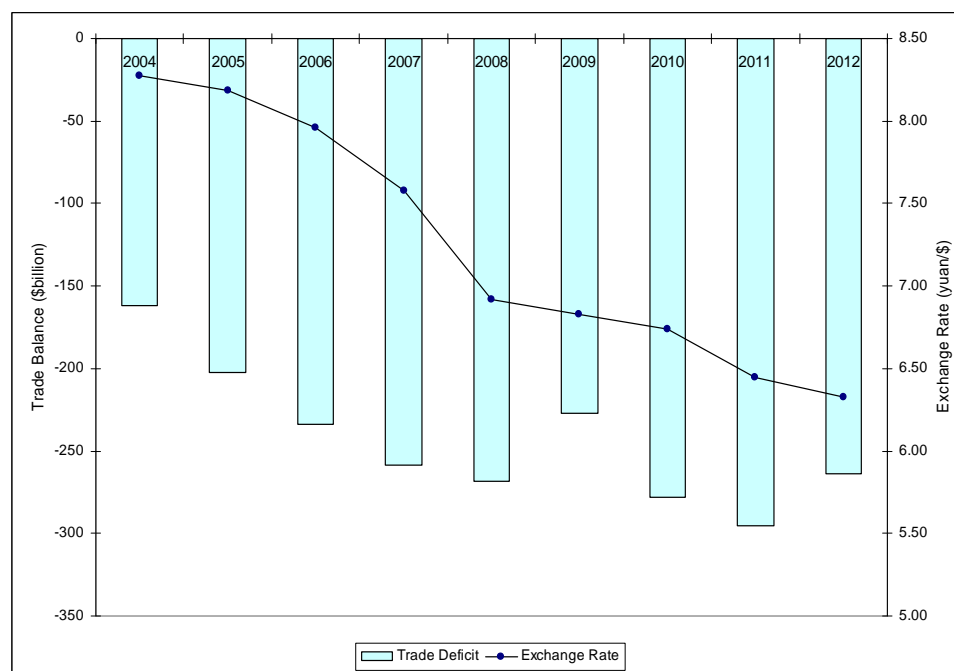
## The U.S. Trade Deficit as an American Problem

- Kotlikoff, L.J. (2008) Saving. <http://www.econlib.org/cgi-bin/printcee.pl>.
- Liu, H.C.K. (2005a) The Coming Trade War and Global Depression, *Asia Times Online*, 18 June.
- Liu, H.C.K. (2005b) Trade Wars Can Lead to Shooting Wars, *Asia Times Online*, 20 August.
- Liu, H.C.K. (2005c) Scarcity Economics and Overcapacity, *Asia Times Online*, 18 June.
- Marks, A. and Scherer, R. (2005) US Savings Rate Falls to Zero, *Christian Science Monitor*, 3 August. <http://articles.moneycentral.msn.com/Investing/Extra/USSavingsRateFallsToZero.asp>
- Moosa, I.A. (2012a) The Magnificent Seven: Reasons why Revaluation of the Yuan will not Work, *International Journal of Economics* (forthcoming).
- Moosa, I.A. (2012b) *The U.S.-China Trade Dispute: Facts, Figures and Myths*, Cheltenham: Edward Elgar.
- Penner, R.G. (2010) Choosing the Nation's Fiscal Future", The President's National Commission on Fiscal Responsibility and Reform, 27 April.
- Persaud, A. (2010) Why China's Exchange Rate is a Red Herring, *Vox*, 10 April.
- Peter Peterson Foundation (2010) State of the Union Finances: A Citizen's Guide, April. [http://www.google.com.au/search?q=%22State+of+the+Union+Finances %3A+A+Citizen%E2%80%99s+Guide%22&ie=utf-8&oe=utf-8&aq=t&rls=org.mozilla:en-US:official&client=firefox-a](http://www.google.com.au/search?q=%22State+of+the+Union+Finances%3A+A+Citizen%E2%80%99s+Guide%22&ie=utf-8&oe=utf-8&aq=t&rls=org.mozilla:en-US:official&client=firefox-a).
- Samuelson, R.J. (2009) Barack Obama's Risky Deficit Spending, *Real Clear Markets*. 18 May. Available at [http://www.realclearmarkets.com/articles/2009/05/barack\\_obamas\\_risky\\_deficit\\_sp.html](http://www.realclearmarkets.com/articles/2009/05/barack_obamas_risky_deficit_sp.html).
- Scott, R. (2008) The China Trade Toll: Widespread Wage Suppression, 2 Million Jobs Lost in the U.S., *EPI Briefing Papers*, No 219, July.
- Stockman, D. (2010) Four Deformations of the Apocalypse, *New York Times*, 31 July.
- The Economist (2010a) Nominally Cheap or Really Dear, 6 November.
- The Economist (2010b) Confronting the Monster, 20 November.
- Walker, D.M. (2008) U.S. Financial Condition and Fiscal Future Briefing, United States Government Accountability Office (GAO-08-446CG), 17 January.

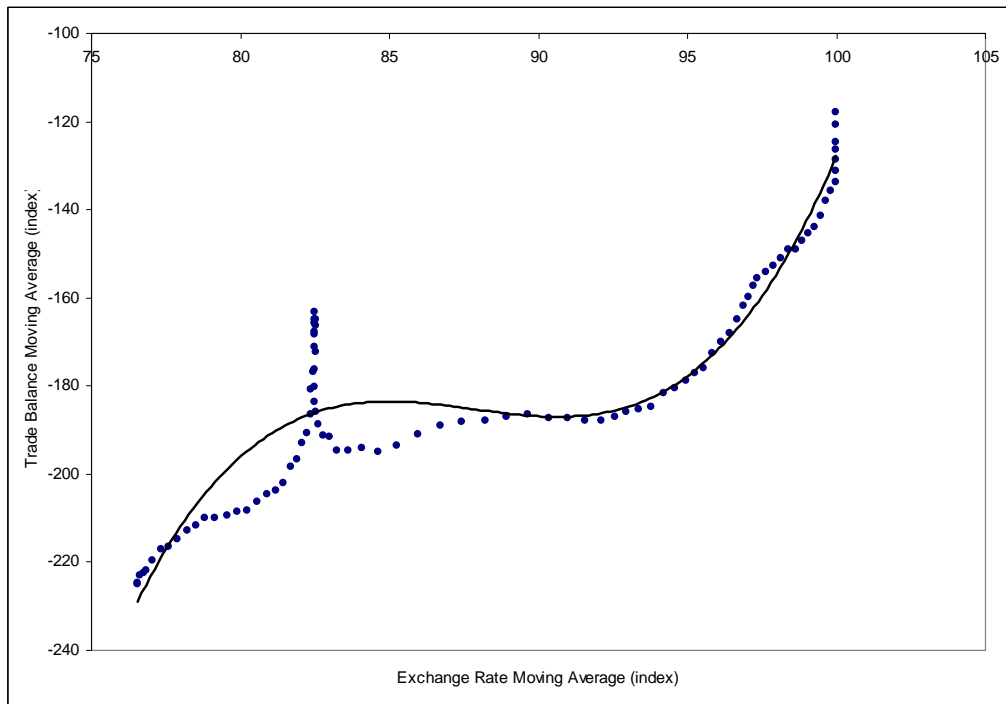
**Figure 1. The U.S. Trade deficit with China and the yuan/\$ exchange rate (monthly figures)**



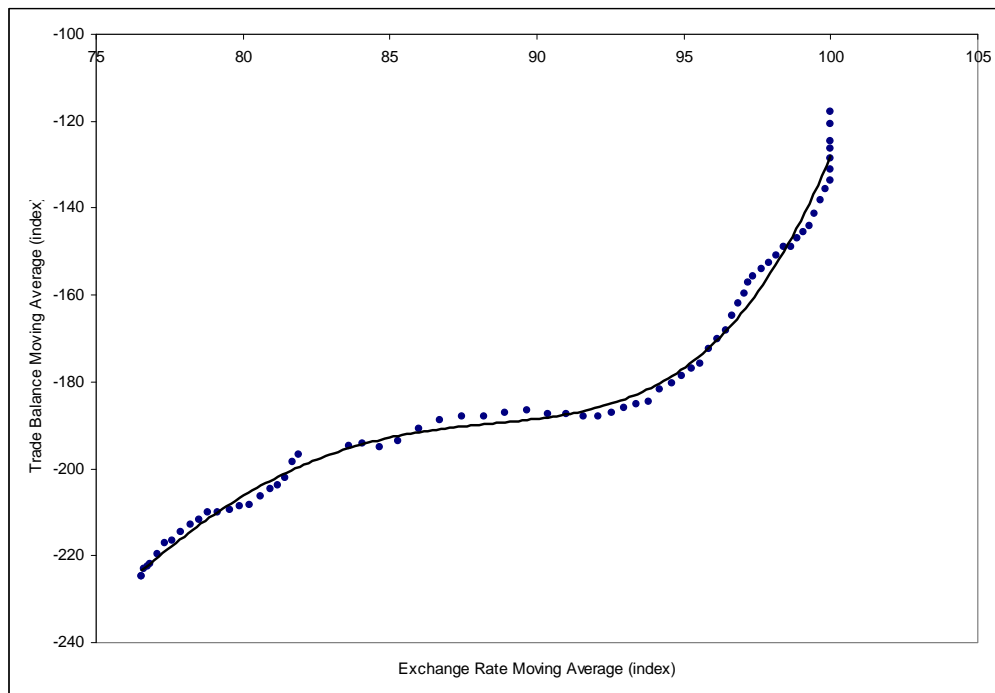
**Figure 2. The U.S. Trade deficit with China and the yuan/\$ exchange rate (annual figures)**



**Figure 3. Moving average Indices of trade deficit and exchange rate**



**Figure 4. Moving average Indices of trade deficit and exchange rate (excluding periods of fixed rates)**



### **About the Authors**

Imad Moosa obtained a BA in economics and business studies, MA in the economics of financial intermediaries and a PhD in financial economics from the University of Sheffield (UK) in 1975, 1976 and 1986, respectively. He has received formal training in model building, exchange rate forecasting and risk management at the Claremont Economics Institute (USA), Wharton Econometrics (USA), and the International Center for Monetary and Banking Studies (Switzerland). Until 1991, Imad had worked as a financial analyst, financial journalist and a professional economist/investment banker. As a result, he gained practical experience in foreign exchange, money market operations, new issues, securities portfolios and corporate finance. He was also an economist at the Financial Institutions Division of the Bureau of Statistics at the International Monetary Fund (Washington, DC). Imad has served in a number of advisory positions with private and public institutions, including KPMG, AUSAID, US Treasury, Central Bank of Kuwait and the United Nations.

### **Contact Information**

The corresponding author: Address: School of Economics, Finance and Marketing, RMIT, 445 Swanston Street, Melbourne, Victoria 3000, Australia. Email: [imad.moosa@rmit.edu.au](mailto:imad.moosa@rmit.edu.au).