Consider the way in which government policy can influence trade. In particular, let’s think about the government budget and the way in which budget deficits can influence the trade deficit. Let’s start with a familiar equation that shows all of the uses of income and the equilibrium condition that spending equals income, rearrange the letters and you get our familiar equation, savings equals investment. All the savings in the economy can either be linked to businesses, linked to the government or linked to foreigners.

Now, let’s consider the way in which the government budget deficit is related to the trade deficit. Suppose the government decides to run a bigger deficit, that is, increase government spending relative to taxes. If the government is going to run a bigger deficit, it’s got to borrow more money. That means issuing more treasury securities. The government is now competing for the scarce pool of savings and it’s going to be driving up the price of savings, that is, pushing up the interest rates. So one effect of the bigger budget deficit is going to be a higher interest rate. Now this higher interest rate is going to have some consequences for international trade. The first is the direct consequence that foreigners want to lend us more money when our interest rate is high relative to the rest of the world. So foreign savings flows into our economy; that is, a capital account surplus. Now remember from balance of payments accounting, the flip side of a capital account surplus is a current account deficit. The thing that makes it possible for us to borrow money from foreigners is that we’re going to start buying more from them than they’re buying from us. That is a trade deficit. So the way we borrow money from foreigners is we start importing more stuff from them than they are buying of our exports. So the flip side of the government budget deficit is going to be a reduction in the trade surplus, or ultimately a growing trade deficit. That’s the direct effect of the interest rate.

The other thing that happens is the higher interest rate makes foreigners want to buy more of our stocks and bonds, increasing the demand for dollars. When the demand for dollars rises relative to the supply, the exchange rate is going to change. The US dollar is going to appreciate with respect to foreign currencies. As the US dollar appreciates, then what begins to happen is people in the United States find that buying goods from foreigners is a bargain. We start spending our stronger dollars on imports so imports increase. Foreigners, meanwhile, find that it’s unattractive to buy goods and services from the US, because the appreciation of the dollar makes our goods and services relatively expensive. So exports are reduced, imports are increased and that gives us a bigger trade deficit. So two channels connecting the government budget deficit with the trade deficit; the first is the interest rate and the second is the exchange rate.

Now, let’s consider then the way in which the government budget deficit and the trade deficit are related to the stocks of debt that stand behind them. Let’s think first about the budget deficit. Each year’s budget deficit is that year’s addition to the national debt. Every year that we run a budget deficit, the government is issuing more government bonds to pay for that year’s government excess of spending over revenue. The outstanding stock of government bonds is the national debt, which is about $5 trillion. Every year that the US Federal Government runs a budget deficit, it’s adding to the national debt, the outstanding stock of government bonds. Every year that the government runs a budget surplus, it can buy back some of that debt and reduce the outstanding national debt, reduce the outstanding stock of government bonds. Just as the budget deficit is each year’s addition to the national debt, the trade deficit is each year’s addition to our foreign debt. Before the 1970’s and 1980’s, the United States was the world’s biggest creditor nation. We had lent lots and lots of money to foreign countries by running balance of payments surpluses by running trade surpluses year after year. As we exported more than we imported, we were lending other people money. Then after the 1980’s, with the US trade deficit occurring year after year at larger and larger levels, we started borrowing more and more money from abroad, until the US nowadays is the world’s biggest debtor nation. Your foreign debt is the amount of corporate and government bonds from your country that are held by foreigners. And every year that you run a trade deficit, foreigners are lending you money. If you run a trade deficit year after year, you’re going to be lent money by foreigners year after year, until your foreign becomes larger and larger. So each year’s trade deficit is that year’s addition to the outstanding foreign debt, where the total amount of your country’s debt or assets that is held by foreigners.

So as we add to the national debt, we are typically adding to the foreign debt, because the government budget deficit usually creates a trade deficit. The two deficits are like twins. If total savings and total business spending doesn’t change, then the way we get extra savings in our economy when the government wants more is we suck it in from
abroad. We get foreigners to lend it to us and the mechanisms that make that happen are changes in the interest rate and changes in the exchange rate.

Take a look at some statistics from January of the year 2000. You can see that, in that month, the United States ran a trade deficit with trading partners China, Japan, Canada and Germany. You can also see that, in the same month, the US had trade surpluses with the Netherlands, Australia, Switzerland, Belgium, Egypt and Turkey. Now if you take all of the countries with which we run trade deficits, add up the amounts of those deficits and add up the amounts of the surpluses from the countries with which we have surpluses, you'll find that the US has a big net deficit with the world as a whole. If you take all of the countries in the world, the US, Canada, Mexico and so forth, you'll find that the trade deficits and the trade surpluses, when added together, sum to zero. For every dollar worth of trade surplus that a country has, some other country somewhere else has a trade deficit, because the sum of deficits and surpluses has to equal zero. Deficits are about countries that import more than they export and the flip side is that capital is flowing into those countries as they borrow the money that allows them to run a trade deficit. Surpluses are about exporting more than you import and those countries are lending money as they lend money to their trading partners, making it possible for the partners to buy more of their country’s exports than the particular country is importing.

So trade and capital flows are intimately linked. A country that’s running a trade deficit is borrowing money, and the sum of borrowings year after year adds up to that country’s foreign debt. A country that is running a trade surplus becomes a creditor to the world and, over time, if it runs a surplus year after year, it becomes a net creditor, a lender, to the rest of the world. So trade and finance are linked in this way.