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Asset Prices and Their Effect on the U.S. Trade Balance

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The U.S. trade deficit has steadily widened since the early 1990s, reaching a level of about 7 percent of gross domestic product (GDP) in 2006. The "trade balance" is the difference between a country's exports and imports. A deficit implies that a country imports (buys from the rest of the world) more than it exports (sells to the rest of the world). When a country has a trade deficit, it sells its assets—bonds, equity, or direct investment—to the rest of the world. In effect, the country is borrowing to finance current consumption. Eventually, these sold assets produce income for their new owners in the rest of the world. This income is paid in dollars, but the rest of the world uses those dollars to buy either more assets or goods and services. Therefore, future U.S. exports must increase to repay the holders of U.S. assets so trade deficits do not grow forever. What factors can push the U.S. trade balance to a more sustainable level?

Some economists have suggested that a large trade deficit should cause the dollar to depreciate. The underlying logic is that a cheaper dollar will lower the price of U.S. exports and raise the domestic price of U.S. imports. Thus, the United States would import less and export more, which would return the trade balance to a more sustainable level. Recent analysis, however, suggests that a dollar depreciation is unlikely to close the trade gap.[1] A problem occurs because the prices of many U.S. imports are denominated in dollars, so the prices that U.S. importers pay are relatively unchanged after a depreciation. As a result, the demand for imports does not decline much, at least in the short term. Although exports are more responsive to exchange rate changes, it is unlikely that an increase in exports is sufficient to close the entire trade gap.

What other forces could drive the trade balance? As the chart shows, pronounced cycles and booms in asset prices have usually accompanied widening trade deficits. For example, U.S. equity prices rose by almost 340 percent between 1990 and 2000 before losing about one-third of their value in the first two years after the dot-com crash. Similarly, housing prices increased by around 130 percent between 1990 and 2007 with a marked increase from the early 2000s until 2007. Moreover, after the subprime crisis that began in the summer of 2007, sharply declining asset prices have brought about an improved trade balance.

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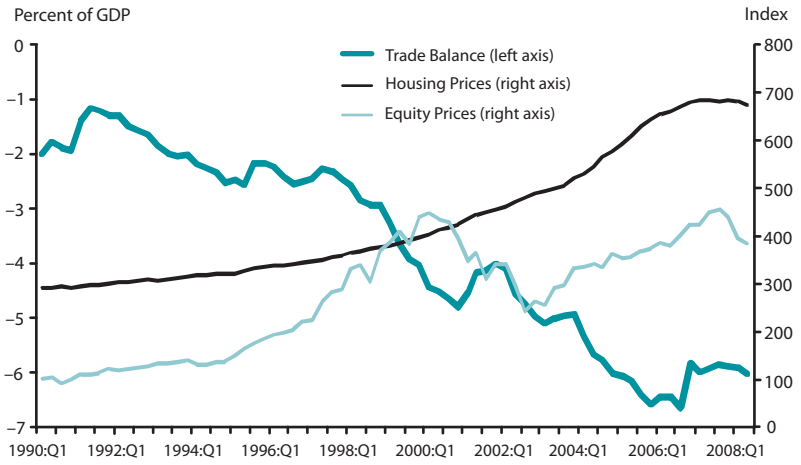
What links exist between asset prices and the trade balance? Rising asset prices are presumably linked to trade deficits because they increase household wealth and spending, as well as make investment cheaper for firms because

Asset Prices and the U.S. Trade Balance as a Percentage of GDP



SOURCE: Bloomberg, Bank for International Settlements, and International Monetary Fund.

they can finance it by issuing equity.[2] Conversely, weakening asset prices might be associated with lower spending, and hence, lower demand for imports.

In conclusion, a large U.S. dollar depreciation could be a key driver of the trade balance adjustment, but recent analysis has questioned its effectiveness. Given the strong links between equity and housing prices and the trade balance, moderating U.S. asset prices could serve as an alternative mechanism to sizably adjust the trade deficit. ■

[1] Goldberg, Linda and Wiske Dillon, Eleanor. "Why a Dollar Depreciation May Not Close the U.S. Trade Deficit." Federal Reserve Bank of New York *Current Issues in Economics and Finance*, June 2007, *13*(5), pp. 1-7; www.newyorkfed.org/research/current_issues/ci13-5.pdf.

[2] Fratzscher, Marcel; Juvenal, Luciana and Sarno, Lucio. "Asset Prices, Exchange Rates and the Current Account." Working Paper No. 2008-031, Federal Reserve Bank of St. Louis, August 2008, revised May 2009; http://research.stlouisfed.org/wp/2008/2008-031.pdf.

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