Why Does the US Always Have a Trade Deficit?
(With Nearly Everyone)

Think of the world as composed of only two countries, Japan and the US in 1900.
The easiest example to understand is to think about Imperial Japanese practices at that time. They required all export receipts to be deposited at the Yokohama Specie Bank in return for yen at the official exchange rate. If an importer wanted to buy any type of import, goods or services, it had to buy foreign exchange from the Yokohama Specie Bank.

If the Imperial Finance Ministry then decided that it should hold foreign exchange reserves equal some percentage of potential imports, it might release only 80% of the annual foreign exchange receipts for use by importers. That would be a rational decision for them to make, even if there were no protectionist intent, because the country was becoming more dependent on *gaijin* (外人). It could then allow Yokohama Specie Bank to invest the remainder with JP Morgan in New York. We had no central bank at the time.

JP Morgan might try to balance domestic credit and export credit by treating the dollar deposit from Tokyo as funds available to finance exports to Japan. It is more likely that they would just view the funds as fungible, an old Federal Reserve term and excuse, and use the new funds for the best available investment for their overall loan and investment portfolio. In that example, as long as Japan always kept international reserves, but the US, represented by JP Morgan, never kept reserves, there would always be a trade deficit with Japan. Quality differentials, price differentials, and people's wants and needs would not make a difference. There would always be a trade deficit with Japan, because Japan would treat the purchase of dollar reserves as an "import," and imports of goods, services, <u>and reserves</u> would be limited by the value of exports.

The only way that the US, represented by JP Morgan, could balance its goods and services trade with Japan would be if JP Morgan intentionally held yen reserves, as compensating balances, with the Yokohama Specie Bank. The issue was easier to understand in 1900 because the reserves were generally in gold or currencies that were convertible to gold on demand. The trade finance accounts were kept in goods, services, <u>and gold, as a separate category</u>. Because the accounts are now held in dollars, WE confuse the difference between trade dollars and reserve dollars, and WE keep no reserves. I emphasized the word WE because WE are one of the few countries that suffer from that confusion. But, for most of the other countries, dollar holdings are reserves. For us they are just spendable funds.

The importance of the exhibit (Hypothetical Reserve Positions) is that 24 currency areas account for 88% of our trade. If we want to have balanced trade <u>with less gaming against us</u>, we have to be willing to manage a trade-weighted portfolio of 20 or 24 currencies. On the surface, there appears to be a COST of holding those currencies. But the cost is really just an income transfer internally, from domestic demand industries and the money center banks to export industries and regional banks. There is so much overlap between those two categories now that the income transfer would be hardly noticed, <u>but behavior would change</u>. Since there would be a value to earning foreign exchange, exporters would get more attention from bankers and policymakers. The RISK of holding foreign exchange reserves would be small because they would be limited to

a percentage of current imports. They could easily be spent down if we chose to cancel a relationship.

Ten country models of the system (G-10), twenty country models (G-20), hundred country models, and two hundred country models all work the same as the two country model above with the US and Japan. As long as we keep no reserves and our trading partners always do, motivated either by prudence or protectionism, we MUST and will have a trade deficit. That cannot be overcome by printing more money as the Fed insists upon doing. Inflating the dollar bubble just makes money traders fatter, while starving domestic producers and workers. It facilitates the discrimination by some of our trade partners against us.

A country that holds reserves, that has exchange controls that prevent easy convertibility, and that requires domestic persons or firms to buy foreign exchange before they can import goods or buy foreign services can easily restrict imports from other countries generally or in a discriminatory manner. The process can become so imbedded in the culture that it becomes considered not politically correct to buy certain foreign goods. It does not always require mandates. But, with currency controls and one-sided reserve management practices, trade imbalances are a necessary outcome.

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A	Q	R	S	T	U	V	W	X	Y	Z	AA	AB
7					HYPOTHETICAL RESERVE POSITIONS							
8												
9				IMPORTS BY CURRENCY AREA				AS OF 11/30/2011				
10				MILLIONS			SOURCE	C/$	$/C	DOLLAR	BLOC	
11			2011				RESERVE	EXCHANGE	EXCHANGE	RESERVE	TRADE	
12		CURRENCY	O NOVEMBEI	ANNUALIZED	PERCENTAGE	CUMULATIVE	TARGET*	RATE	RATE	TARGET	BALANCE	ANNUALIZED
13	1	RENMINBI YUAN	$366,493	$399,811	18.11%	18.11%	638,550	6.38853	$0.1565	$99,953	($272,321)	($297,077)
14	2	CANADIAN DOLLAR	$289,970	$316,331	14.33%	32.44%	81,660	1.03259	$0.9684	$79,083	($31,697)	($34,579)
15	3	EURO AREA	$259,450	$283,036	12.82%	45.26%	52,036	0.73539	$1.3598	$70,759	($79,966)	($87,236)
16	4	MEXICAN PESO	$241,848	$263,834	11.95%	57.21%	891,911	13.5223	$0.0740	$65,959	($60,616)	($66,127)
17	5	JAPANESE YEN	$116,879	$127,504	5.78%	62.99%	2,442,346	76.62	$0.0131	$31,876	($56,102)	($61,202)
18	6	SOUTH KOREAN WON	$52,146	$56,887	2.58%	65.57%	16,717,534	1175.5	$0.000851	$14,222	($12,608)	($13,754)
19	7	BRITISH POUND	$46,391	$50,608	2.29%	67.86%	8,096	0.63987	$1.5628	$12,652	$4,663	$5,087
20	8	SAUDI ARABIAN RIYAL	$42,362	$46,213	2.09%	71.93%	43,323	3.74981	$0.2667	$11,553	($30,059)	($32,792)
21	9	VENEZUELAN BOLIVAR	$40,097	$43,742	1.98%	69.84%	46,912	4.28988	$0.2331	$10,936	($28,856)	($31,479)
22	10	TAIWAN NTD	$38,219	$41,693	1.89%	73.82%	317,359	30.4469	$0.0328	$10,423	($14,601)	($15,928)
23	11	INDIAN RUPEE	$33,554	$36,604	1.66%	77.06%	454,047	49.6167	$0.0202	$9,151	($13,895)	($15,158)
24	12	NIGERIAN NAIRA	$31,923	$34,825	1.58%	75.40%	1,366,101	156.91	$0.00637	$8,706	($27,586)	($30,094)
25	13	RUSSIAN ROUBLE	$31,701	$34,583	1.57%	78.62%	275,873	31.9086	$0.0313	$8,646	($24,202)	($26,402)
26	14	BRAZILIAN REAL	$27,938	$30,478	1.38%	80.00%	13,915	1.82622	$0.5476	$7,619	$11,616	$12,672
27	15	MALAYSIAN RINGGIT	$23,694	$25,848	1.17%	81.17%	20,566	3.18259	$0.3142	$6,462	($10,579)	($11,541)
28	16	THAILAND BAHT	$23,103	$25,203	1.14%	82.32%	196,087	31.1208	$0.0321	$6,301	($12,937)	($14,113)
29	17	SWISS FRANC	$22,299	$24,326	1.10%	83.42%	5,455	0.89704	$1.1148	$6,082	($336)	($367)
30	18	COLOMBIAN PESO	$20,931	$22,834	1.03%	84.45%	10,837,387	1898.48	$0.000527	$5,708	($7,830)	($8,542)
31	20	INDONESIA RUPIAH	$17,738	$19,351	0.88%	86.21%	43,077,797	8904.72	$0.000112	$4,838	($11,037)	($12,040)
32	19	SINGAPORE DOLLAR	$17,723	$19,334	0.88%	85.33%	6,261	1.29527	$0.7720	$4,834	$10,994	$11,993
33	21	ALGERIAN DINAR	$13,575	$14,809	0.67%	86.88%	273,405	73.8478	$0.0135	$3,702	($14,601)	($15,928)
34	22	AUSTRALIAN DOLLAR	$9,250	$10,091	0.46%	87.33%	2,576	1.0211	$0.9793	$2,523	($4,137)	($4,513)
35	23	CHILEAN PESO	$8,326	$9,083	0.41%	87.74%	1,166,927	513.9	$0.0019	$2,271	$897	$979
36	24	SOUTH AFRICAN RAND	$8,788	$9,587	0.43%	88.18%	18,932	7.89919	$0.1266	$2,397	$4,802	$5,239
37												
38		SUBTOTAL	$1,784,398	$1,946,616	88.18%					$486,654	($680,994)	($742,903)
39												
40		OTHER COUNTRIES	$239,218	$260,965	11.82%					$65,241	$11,485	$12,529
41												
42		TOTAL	$2,023,616	$2,207,581	100.00%	100.00%				$551,895	($669,509)	($730,373)
43												
44		OPEC COUNTRIES ABOVE	$127,957	$139,589	6.32%					$34,897	($101,102)	($110,293)
45							*SOURCE CURRENCY					
46							AT 25% OF ANNUAL IMPORTS					