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CSI: Trade Deficit

by PAUL KRUGMAN

Forensics are in. If you turn on the TV during prime time, you're likely to find yourself watching people sorting through clues from a crime scene, trying to figure out what really happened.That's more or less what's going on right now among international finance experts. The crime in question is the U.S. trade deficit, which according to the broadest measure reached an amazing $805 billion last year. The mystery is how we've been able to run huge deficits, year after year, with so few visible adverse consequences. And the future of the U.S. economy depends on which of two proposed solutions to the mystery is right.

Here's the puzzle: the trade deficit means that America is living beyond its means, spending far more than it earns. (In 2005, the United States exported only 53 cents' worth of goods for every dollar it spent on imports.) To pay for the excess of imports over exports, the United States has to sell stocks, bonds and businesses to foreigners. In fact, we've borrowed more than $3 trillion just since 1999.

By rights, then, the investment income - interest payments, stock dividends and so on - that Americans pay to foreigners should be a lot larger than the investment income foreigners pay to Americans. But according to official statistics, the United States still has a slightly positive balance on investment income.

How is this possible? The answer, almost certainly, is that there's something wrong with the numbers. (Laypeople tend to treat official statistics as gospel; professional economists know that putting these numbers together involves a lot of educated guesswork - and sometimes the guesses are wrong.) But depending on exactly what's wrong, the U.S. economy either has hidden strengths, or it's in even worse shape than it seems.

In one corner are economists who think the official statistics miss invisible U.S. exports - exports not of goods and services, but of intangibles like knowledge and brand-name recognition, which allow U.S. companies to earn high rates of return on their foreign investments.

Proponents of this view claim that if we counted these invisible exports, which they call "dark matter," much of the U.S. trade deficit would disappear.

The dark matter hypothesis has been eagerly taken up by some journalists, who like its upbeat message. It seems to say that the U.S. economy is, as a cover article in Business Week put it, "much stronger than you think."

But there's a problem: U.S. companies operating abroad don't, in fact, seem to earn especially high rates of return. Why, then, doesn't the United States seem to be paying a price for all its borrowing? Because according to the official data, foreign companies operating in the United States are remarkably unprofitable, earning an average return of only 2.2 percent a year.

There's something wrong with this picture. As Daniel Gros of the Center for European Policy Studies puts it, it's hard to believe that foreigners would continue investing in the United States "if they were really being constantly taken to the cleaners."

In a new paper, Mr. Gros argues - compellingly, in my view - that what's really happening is that foreign companies are understating the profits of their U.S. subsidiaries, probably to avoid taxes, and that official data are, in particular, failing to pick up foreign profits that are reinvested in U.S. operations.

If Mr. Gros is right, the true position of the U.S. economy isn't as bad as you think - it's worse. The true trade deficit, including unreported profits that accrue to foreign companies, isn't $800 billion - it's more than $900 billion. And America's foreign debt, including the value of foreign-owned businesses, is at least $1 trillion bigger than the official numbers say.

Of course, optimists have a comeback: if things are really that bad, why are so many foreign investors still buying U.S. bonds? And they point out that those predicting problems from the trade deficit have been wrong so far. But I have two words for those who place their faith in the judgment of investors, and believe that a few good years are enough to prove the skeptics wrong: Nasdaq 5,000.

Right now, forensic analysis seems to say that the U.S. trade position is worse, not better, than it looks. And the answer to the question, "Why haven't we paid a price for our trade deficit?" is, just you wait.