Trump & gang's trade deficit delusions could be disastrous for all and sundry

They fail to understand what is quite a complex issue, and yet are proposing solutions to reduce the deficit that would only make it worse, hurting not only America but the rest of the world as well.

by
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Since 1981, the US has run a trade deficit while Japan has run a trade surplus, yet the US economy has grown faster than Japan's, which has now endured more than two decades of stagnation. PHOTO: AFP

IF THERE is a single number that US President Donald Trump is obsessed with (besides the number of people who attended his inauguration), it is the US trade deficit, which he sees as indicative of US economic weakness, motivating his push for protectionist trade policies.
In this, he is supported by the head of his newly-created National Trade Council, economist Peter Navarro, and his nominee for Commerce Secretary, billionaire private-equity investor Wilbur Ross. Their thinking is at odds with that of other members of his administration, mainstream Congressional Republicans, and nearly all professional economists.

Regardless, the White House is now considering recalculating trade balances to exclude re-exports, that is goods which the US imports (say, from Mexico) and then re-exports (say, to Canada). This would inflate the size of the US trade deficit, presumably providing more ammunition for Mr Trump's plan to abrogate or renegotiate Nafta and other trade agreements.

It could turn the US's bilateral surplus with Singapore into a deficit, adding the republic to the list of countries that could be accused of “currency manipulation” and thus subject to future punitive trade barriers (or abrogation of the US-Singapore Free Trade Agreement).

The trade deficit measures the excess of a country's imports of goods over its exports. The more relevant concept is the current account balance, which includes imports and exports of services as well as physical goods. Thus, the US has a merchandise trade deficit but a services account surplus, so its current account deficit which sums the two is smaller than its merchandise trade deficit. In this article, I will use the two terms interchangeably.

A trade deficit is not necessarily a sign of economic weakness any more than a trade surplus (excess of exports over imports) is a sign of strength. Since 1981, the US has run a trade deficit while Japan has run a trade surplus, yet the US economy has grown faster than Japan's, which has now endured more than two decades of stagnation.

Countries tend to run trade deficits when domestic demand for goods and services is so strong that it cannot be satisfied by domestic production alone, requiring high imports and diverting exportable goods into supplying the domestic market. When domestic demand is weak, as in a recession, imports fall and domestic excess supply is exported instead. Thus when a fast-growth economy trades with a low-growth one, the former will run a bilateral trade deficit and the latter a surplus, exactly the situation of the US and Japan over the past three-plus decades.

Domestic demand is determined by household consumption, business investment, net government expenditure (measured by the budget balance between tax revenues and government spending) and net exports. Mathematically, the current account balance is calculated thus:

\[(\text{Exports less Imports}) = (\text{Savings less Investment}) + (\text{Tax Revenues less Government Expenditure})\]

A country thus runs a trade deficit only if its businesses invest more than its households save, and/or its government runs a budget deficit, that is, when either or both private and public spending are too high. The US's high consumption/low savings and persistent budget deficits are what cause its chronic trade/current account deficits, whereas Japan's low consumption/high savings result in frequent trade surpluses despite large government budget deficits.

Note from this statistical model that foreign import barriers cannot be the cause of a trade deficit, nor can trade liberalisation agreements which require members to mutually reduce their trade barriers.

UNFAIR TRADE

This is where currencies come in. Mr Trump and Mr Navarro blame foreign countries' “currency manipulation” for the "unfair trade" which they claim results in the US trade deficit. In a freely-floating market-determined exchange rate system, the currency of a country running a trade deficit will weaken as its residents sell more of it to buy foreign currency to pay for imports, than foreign countries buy to pay for its exports. As the currency weakens, residents reduce their purchase of imports which become more expensive in local currency, while foreigners increase their purchase of the depreciating currency country's exports as they become cheaper in foreign currency.

Similarly, the currency of a country with a trade surplus will strengthen due to strong foreign demand for its exports and its weak demand for foreign currency to buy imports. This will cause the surplus country's exports to decline as they become more expensive for foreigners, while imports increase as they become cheaper in local currency. In both cases, the trade imbalance diminishes or disappears.
Why then has the US trade deficit not disappeared over more than 30 years? The US runs a trade deficit whether there is domestic growth or recession, a strong or weak dollar. This is because demand for the dollar is fed not just by foreign demand for American goods and services, but to a larger extent, by demand for US financial assets, particularly US Treasuries, or bonds which the US government issues to fund its budget deficit (since it does not raise enough tax revenues to pay for its expenditures).

About 30 per cent of Treasury buyers are foreigners, who also demand dollars to buy US stocks, real estate and other assets. As foreign purchases and sales of dollars wax and wane, so does its value and hence the competitiveness of traded goods and services.

Because the dollar is the most popular world “reserve currency”, people hold it for its own sake (as a “medium of exchange” or “store of value”) rather than to buy American goods and services. For all countries with a freely-floating market-determined exchange rate, the current account balance mirrors the financial account balance measuring net demand for assets. A financial account surplus is required to pay for a current account (trade) deficit: running a trade deficit means the country is receiving a net inflow of capital from abroad (to pay for those excess imports). This boosts its GDP growth by increasing the supply and lowering the cost of capital, thus increasing consumption and investment.

Recognising this, president Ronald Reagan dismissed concerns that the large federal budget deficits resulting from his administration’s tax cuts and government spending increases created budget deficits and increased the national debt. He noted that the trade deficit simply meant that “this is the best country in the world to put your money in” as reflected in the financial account surplus/net capital inflow. This has enabled Americans to spend more than they earn, living beyond their means, but also enjoying higher investment, growth, and incomes - simply because they can borrow in their own currency and foreigners are willing to lend them the money to do so.

Some say that this market-created special reserve currency role of the dollar is an "unfair advantage" for the US, enabling it to borrow cheaply from abroad without currency risk. Others say it will eventually cripple the economy by increasing the national debt, a significant portion of which has to be repaid in foreign currency to foreign lenders.

Foreign demand to hold the dollar also strengthens it, making exports expensive and imports cheap, thereby contributing to the trade deficit. And if and when this foreign willingness to lend diminishes, and net capital inflow declines or reverses, the dollar will depreciate, raising inflation and interest rates. This will make debt repayment more expensive and slow future growth. But it will also shrink the trade deficit, as Mr Trump desires!

In China’s case, persistent current account surpluses, especially with the US, have not self-destructed because for many years the yuan was prevented from rising by “recycling” excess dollar export earnings into US Treasury holdings, rather than converting them into yuan, which would have strengthened the currency, making exports more expensive.

It is this exchange rate management which has caused many US administrations to accuse China of “currency manipulation” to keep its exports artificially cheap. But the main reason for persistent Chinese surpluses is the country’s very high domestic savings, or suppressed consumption, including of imports. Today, China’s financial authorities are intervening to strengthen rather than weaken their currency, including by selling record amounts of US Treasuries.

**CURRENCY MANIPULATION**

There is a suggestion that the Trump administration should attack “currency manipulation” on a global basis, in order to avoid appearing to target (and thus antagonise) China. In this case, Singapore would be vulnerable, given our persistently large current account surpluses and managed exchange-rate regime. Already, Taiwan and Switzerland, in the same situation, have taken to intervening to strengthen their currencies against the rising US dollar, to avoid being accused of “currency manipulation”.

So how is the Trump administration “deluded” in focusing on the trade deficit and proposing policies which will actually worsen rather than improve it?

First, the trade deficit is not the problem that they claim, and is not a sign of economic weakness or of being “taken advantage of” by other countries.

Second, the trade deficit is not caused by foreign trade partners’ unfair trade practices or by bad trade agreements, so it cannot be eliminated by changing these. The trade deficit results from excess domestic demand - low savings and budget deficits which persist because foreign capital inflows, responding to the US dollar’s “safe haven” status, keep interest rates lower, investment and growth higher, the dollar stronger, and the trade deficit larger, than would otherwise be the case.
Third, Mr Trump’s proposals to cut taxes, increase infrastructure and military spending, and maintain Social Security and Medicare (entitlements comprising some two-thirds of government spending), will vastly increase the budget deficit and with it the trade deficit.

Fourth, the higher inflation likely to result from such a large fiscal stimulus in an economy with little spare capacity will compel the Federal Reserve to raise interest rates further and faster. This will strengthen the dollar, hurting US exports and increasing imports, worsening the trade deficit.

Fifth, threatened policies to impose large tariffs or “border taxes” on imports, particularly from Mexico and China, will increase domestic costs and foreign retaliation, again hurting US exports and worsening the trade deficit.

The trade deficit is a complex issue not well understood by Mr Trump, his supporters or most of his opponents, including former Democratic presidential candidate Senator Bernie Sanders. It is unfortunate that it has become a siren call for policies that are not only unnecessary, but self-defeating, and possibly disastrous for the US economy, and thus the world as a whole.

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