Trade Policy and the U.S. Trade Deficit

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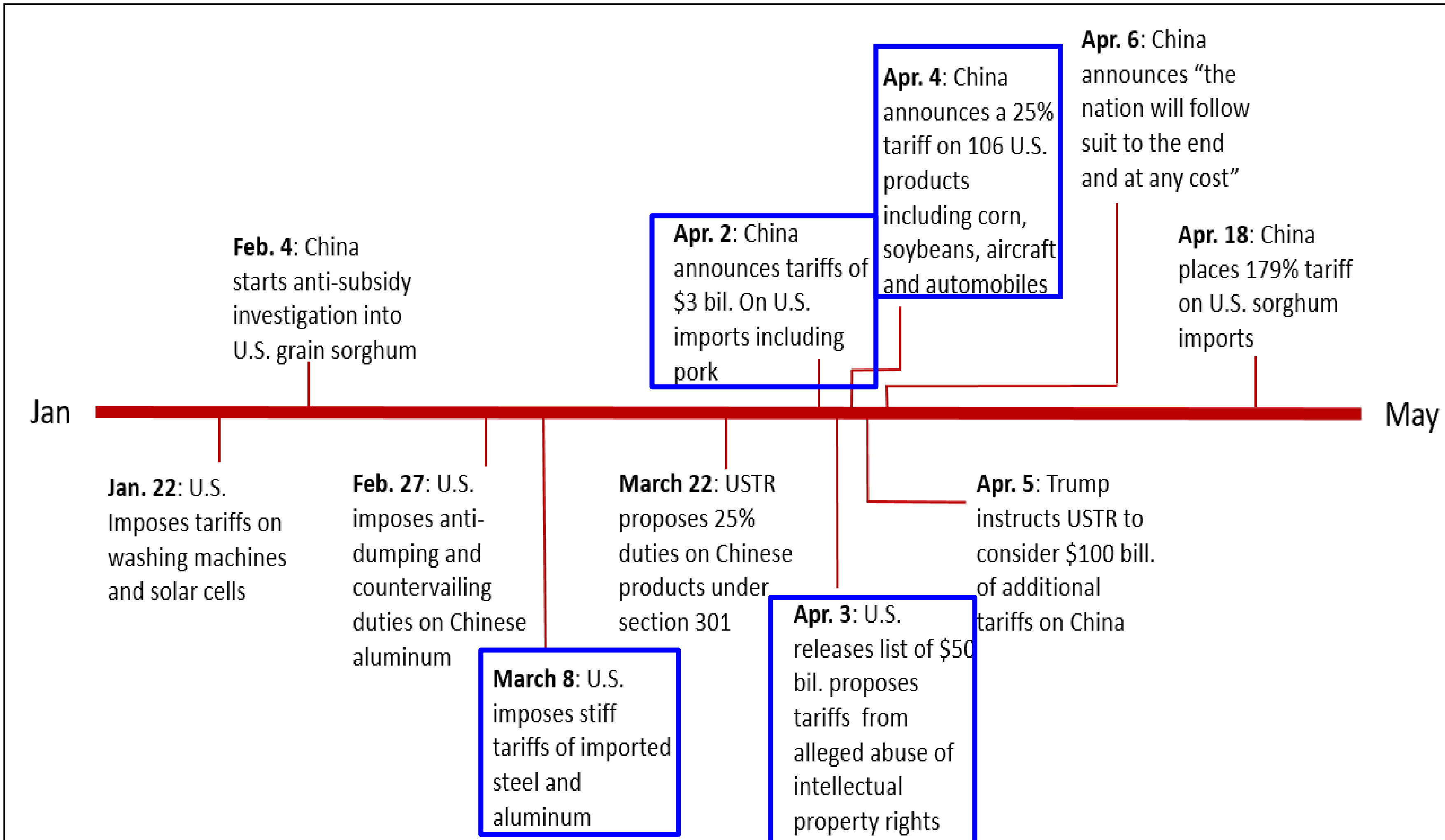
What is Driving U.S. Trade Policy?

- Administration has expressed view international trade is a zero-sum game
- Form of 21st Century *mercantilism* - i.e., imports are bad and exports are good
- Implies no net benefits from open trading system
- Trade deficit seen as evidence that U.S. is losing and other countries must be winning
- Objective of getting China to reform system that discriminates against foreign firms, e.g., transfer of technology through joint ventures

Key Trade Policy Actions

- Trans-Pacific Partnership (TPP) not ratified
- Implementation of tariffs on steel and aluminum imports on grounds of national security
- Allies (Canada/EU/Mexico) not given exemptions on steel and aluminum tariffs – retaliation
- Renegotiation of NAFTA – "…the new USMCA looks a lot like the old NAFTA…" (Joe Glauber, Former Chief Economist at USDA)
- Holding up WTO dispute settlement mechanism
- Steady escalation of trade war with China

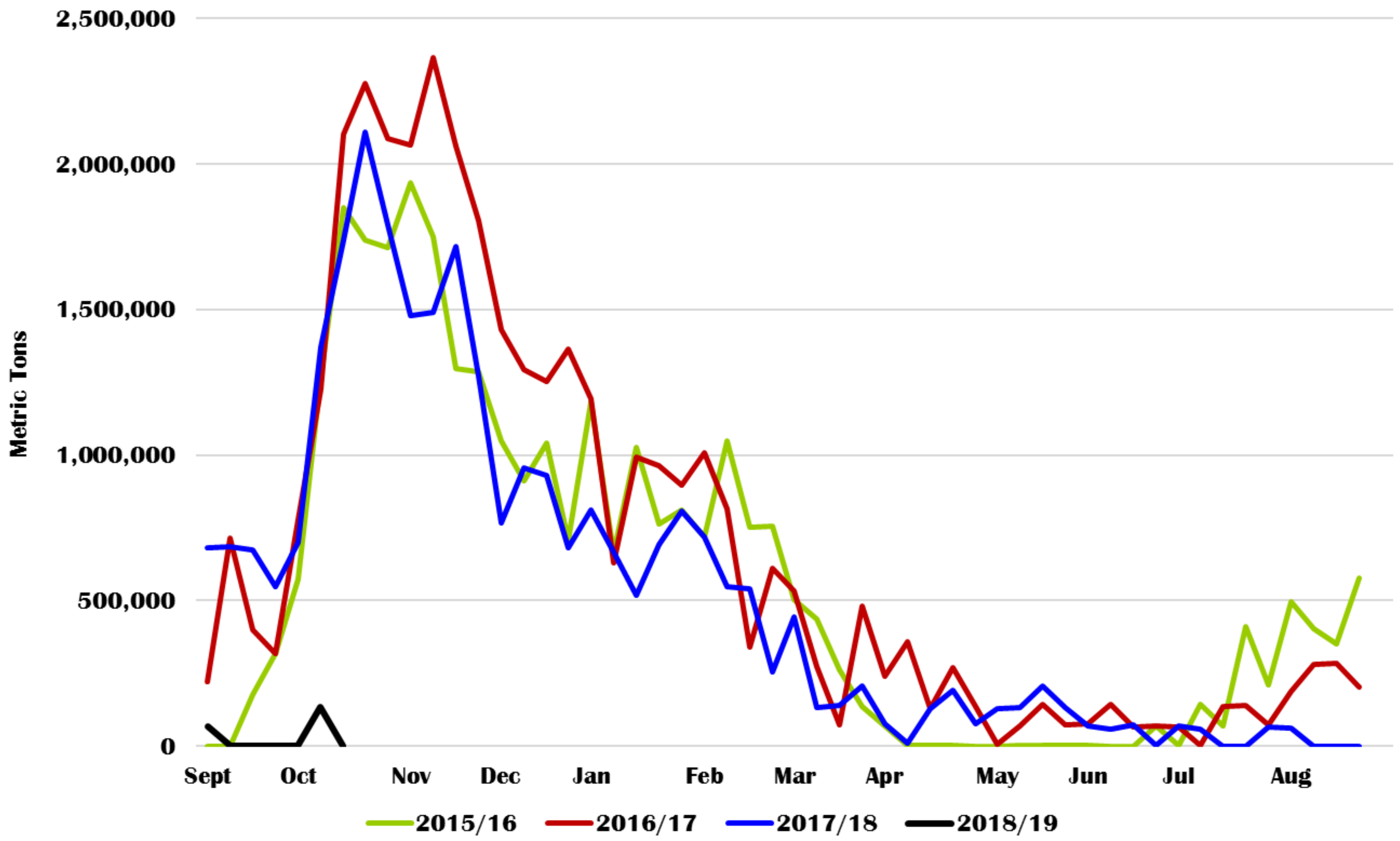
Agriculture Caught in Crossfire



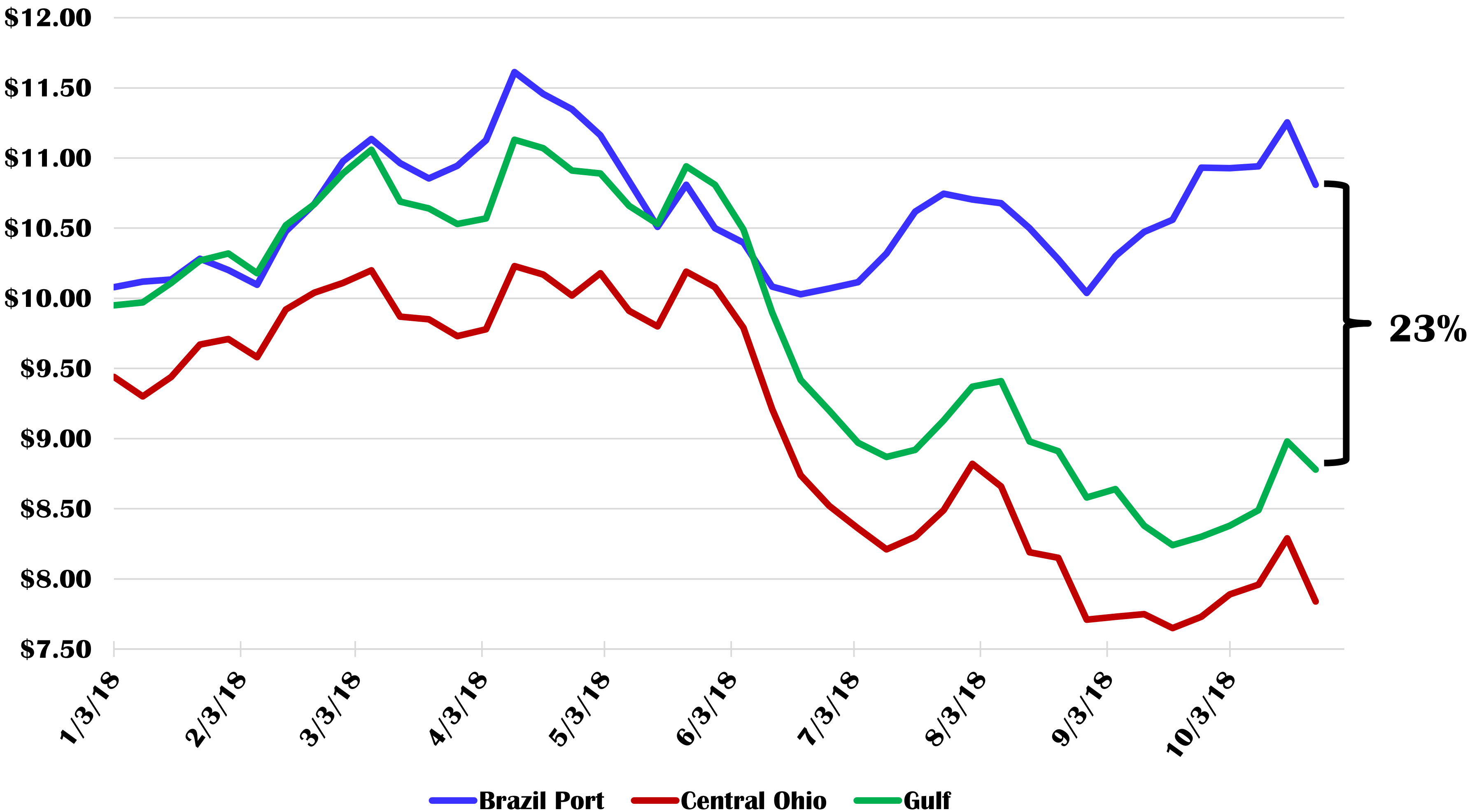
Soybean Tariffs

- China implemented discriminatory tariff of 25% on U.S. imports of soybeans
- Significant reduction in U.S. soybean exports to China compared to last few marketing years
- Gap between U.S, and Brazilian export prices currently 23% (26% on average for September)
- Major substitution to imports of Brazilian soybeans by China
- If trade war persists, clear potential for U.S. to lose market share to Brazil – 9million acres of soybeans (Wally Tyner, Purdue University)

U.S. Soybean Exports to China



Soybean Prices - $/bu.



Bilateral Trade Balances

- **Chinese tariff targeting U.S. soybean imports has resulted in significant *trade diversion* to Brazil**
- **As a consequence, China's trade surplus with U.S. has actually increased - highlighting fallacy of focusing on bilateral trade balances**
- **Most countries run mixture of surpluses and deficits with their different trading partners – very typical in context of value chains**
- **The overall external position of a country is driven by balance between its domestic savings and investment – this is macroeconomics 101!!**

National Income Accounting

- Accounting identity:

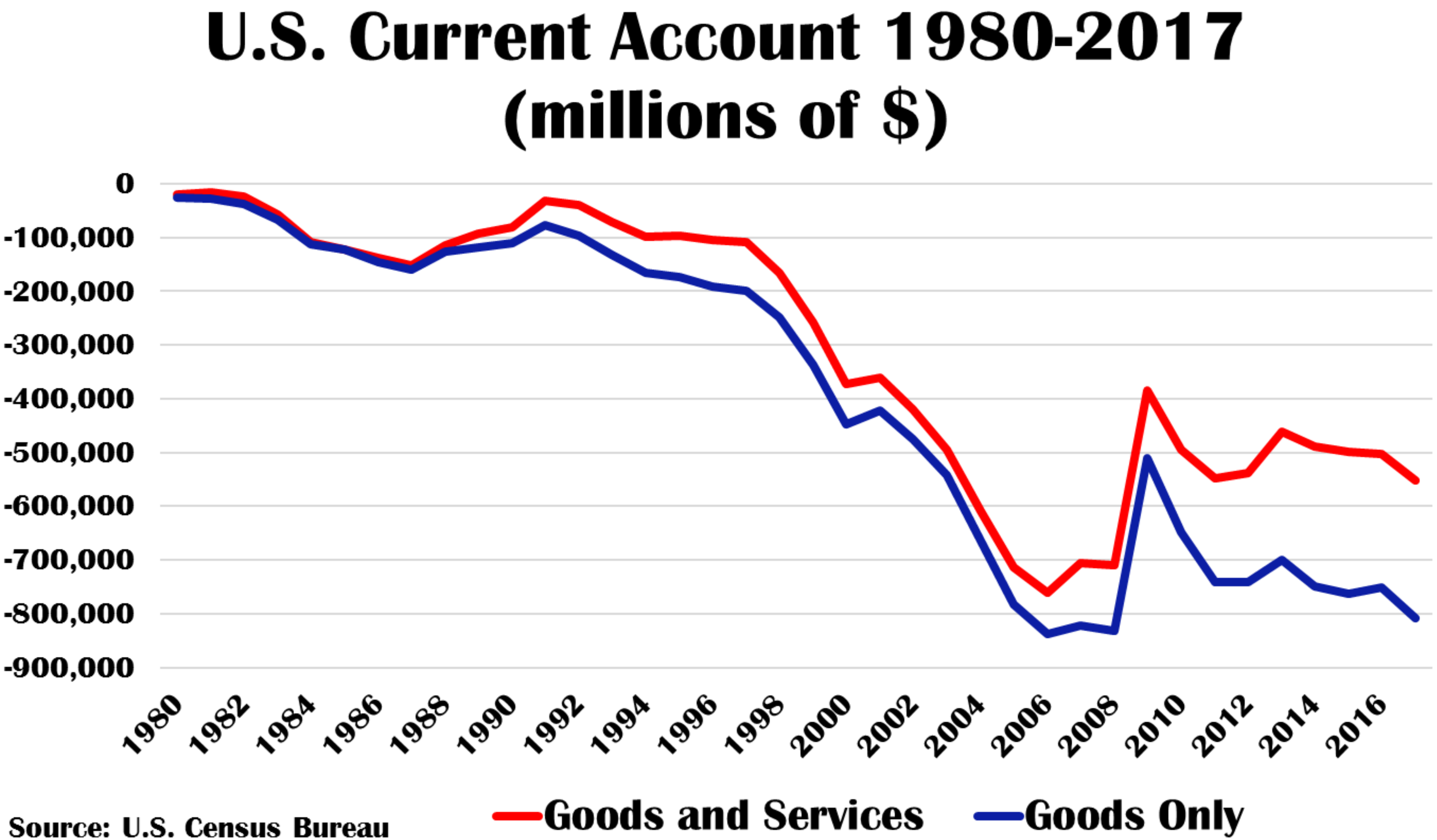
$$\underset{\text{Supply}}{Y} = \underbrace{C + I + G}_{\text{Demand}} + \underbrace{(X - M)}_{\text{Current Account}}$$

- Current account:

$$(X - M) = Y - (C + I + G)$$

- With trade deficit, imports make up difference between what U.S. residents supply and demand
- What is root cause of U.S. trade deficit?
- Need to see connection between flows of goods and services and financial flows

U.S. Trade Deficit



Source: U.S. Census Bureau

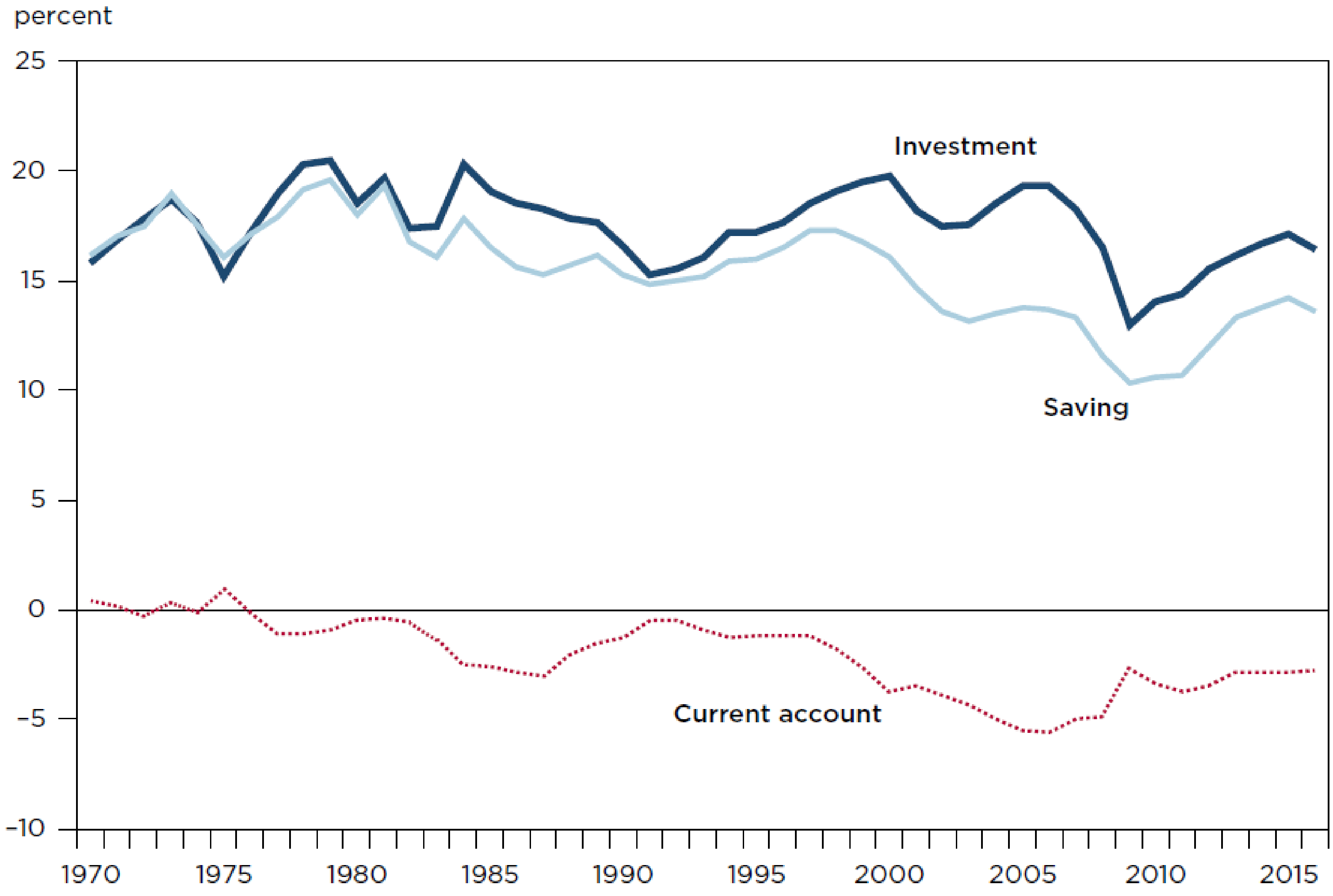
Savings and the Trade Deficit

- Savings: $S = (Y - T - C) + (T - G) \longrightarrow S = Y - C - G$

  $$(X - M) = Y - (C + I + G) \longrightarrow (S - I)$$

  i.e., current account is difference between national savings S and investment I
- Since 1980s, as percentage of GDP, U.S. investment has exceeded savings, and at same time U.S. has consistently run a trade deficit
- Difference made up by capital inflows as foreigners accumulate U.S. financial assets
- U.S. capital account surplus offsets its current account deficit, i.e., the U.S. balance of payments "balances"

Savings and Trade Balance



Source: Bureau of Economic Analysis

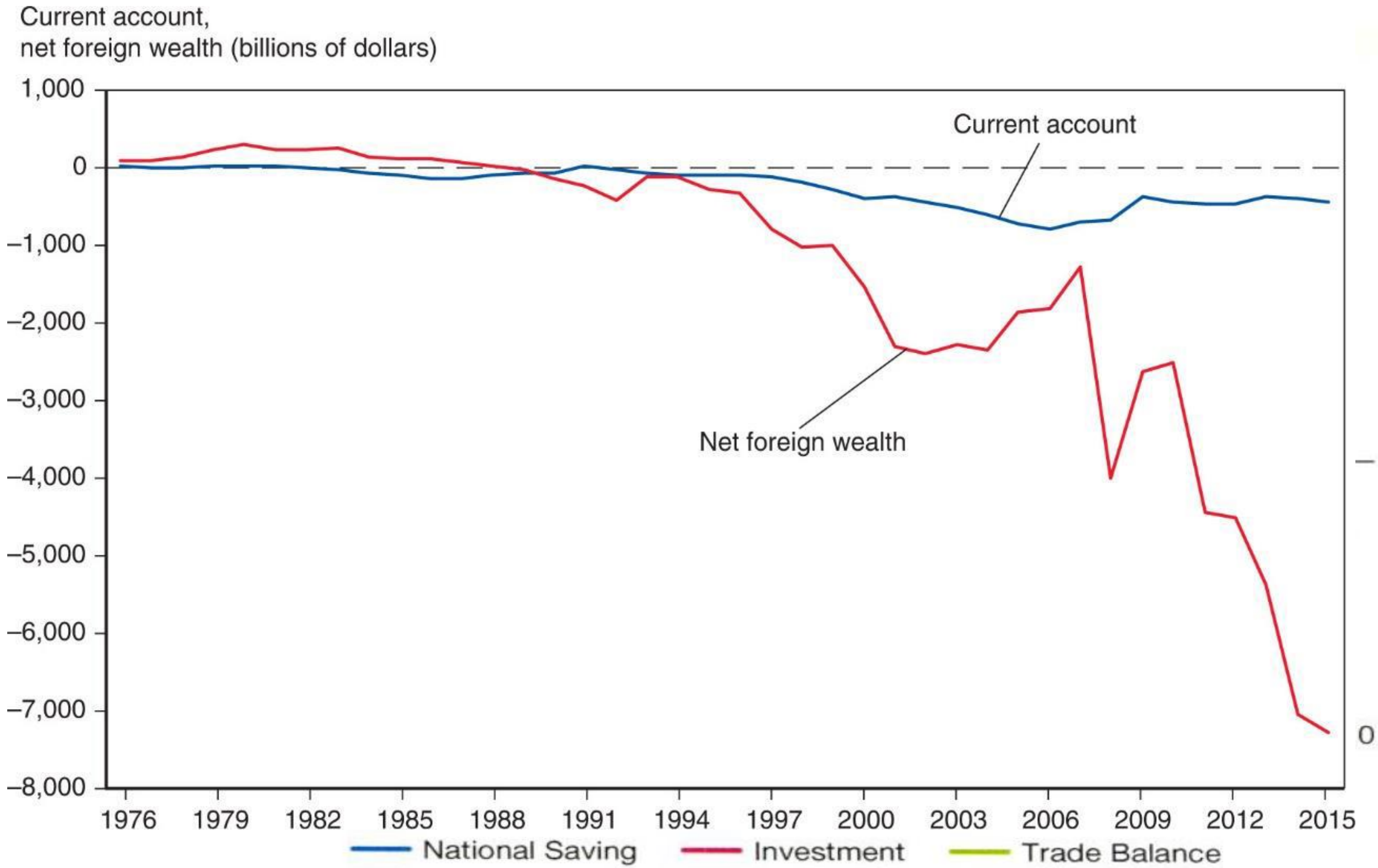
Cause of U.S. Trade Deficit

- Most economists agree U.S. trade deficit driven by decline in national savings rate – both private and public
- U.S. households have high marginal propensity to consume and U.S. government has propensity to run fiscal deficits
- Trade deficit will continue unless savings increase and/or investment falls
- Any increase in fiscal deficit will feed into trade deficit – exacerbated by fact that U.S. economy is running at full employment

Should We Be Concerned?

- To facilitate trade deficit, U.S. runs negative net international investment position (NNIP)
- NNIP is U.S. financial claims on other countries minus foreign financial claims on U.S.
- 2016 NNIP = -$8.4 trillion, i.e., -45% of GDP and expected to increase to -53% by 2021
- Many economists believe this is not sustainable in long run, requiring significant depreciation of US $ with major adjustment costs
- The longer U.S. trade deficit continues, the more extreme relative price adjustment will likely be

NNIP and U.S. Trade Deficit



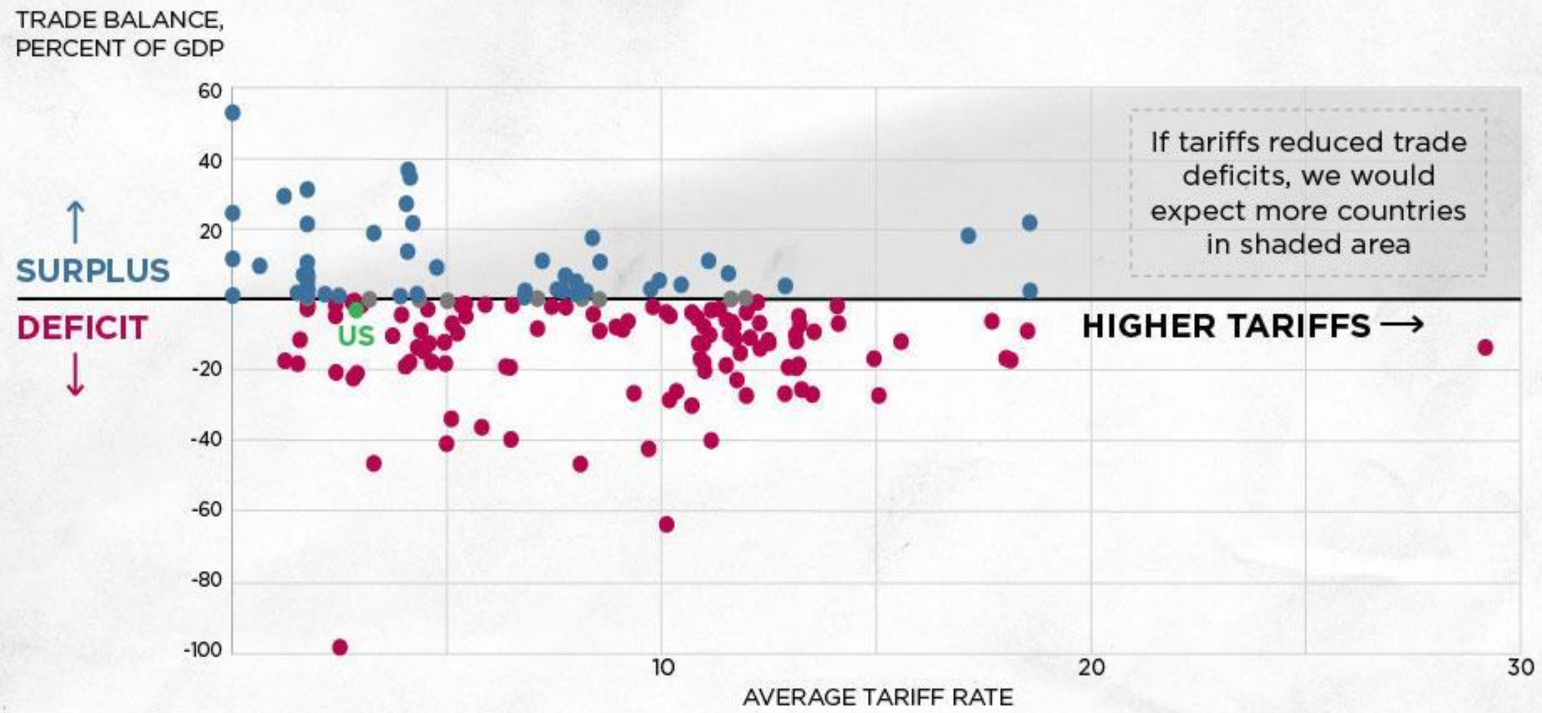
Source: Bureau of Economic Analysis

Trade Policy Won't Fix It

- Economists agree: bilateral trade policy will not solve U.S. trade deficit – diverts trade to other countries/products
- Tariffs reduce imports, but also reduce exports, i.e., lower imports reduces demand for foreign currency, $ strengthens, exports decline
- Essentially U.S. trade deficit is a macroeconomic phenomenon that can only be resolved through macroeconomic policy
- Policy choices: (i) Tax consumption/reduce fiscal deficit; (ii) Depreciate exchange rate; (iii) tax capital inflows

Trade Policy and Trade Deficits

Countries with Higher Tariffs Have Larger Trade Deficits



Note: Data is from 2012-15. Trade balance is the value of goods and services exported minus the value imported. Each dot represents one country; 183 total.

Source: World Bank, World Development Indicators; compiled by Caroline Freund.

Learn more at https://piie.com/research/piie-charts/countries-higher-tariffs-have-larger-trade-deficits

PIIE Chart by Melina Kolb.

#PIIECharts

PIIE Charts

Possible Policy Solution

- Combine managed depreciation of $ along with policies designed to raise U.S. savings
- Ideally fiscal deficit would be cut by raising national savings, interest rates being kept down, contributing to depreciation of $
- Without fiscal contraction, depreciation of $ would result in inflation, leading to higher interest rates
- Higher interest rates would encourage private savings and discourage private investment, but would also make U.S. assets more attractive, i.e., effect of depreciation would be countered

Concluding Thoughts

- Trade is a positive-sum game: $2.1 trillion extra U.S. GDP since 1950 (Hufbauer and Lu, 2017)
- Import tariffs will not solve U.S. trade deficit
- Potential loss of soybean export market share is significant unintended consequence of trade war
- Legitimate concerns about trade with China: e.g., theft of U.S. intellectual property rights (IPRs) – $50 billion/year (USTR, 2018)
- U.S. and allies should put pressure on China to conform to WTO rules (Lawrence, 2018) – but EU and others forced to retaliate against U.S. steel/aluminum tariffs