Trade Policy and the U.S. Trade Deficit

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Ian Sheldon
sheldon.1@osu.edu
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

Jan

Jan. 22: U.S. imposes tariffs on washing machines and solar cells

Feb. 4: China starts anti-subsidy investigation into U.S. grain sorghum

Feb. 27: U.S. imposes anti-dumping and countervailing duties on Chinese aluminum

March 8: U.S. imposes stiff tariffs of imported steel and aluminum

March 22: USTR proposes 25% duties on Chinese products under section 301

Apr. 2: China announces tariffs of $3 bil. on U.S. imports including pork

Apr. 3: U.S. releases list of $50 bil. proposes tariffs from alleged abuse of intellectual property rights

Apr. 4: China announces a 25% tariff on 106 U.S. products including corn, soybeans, aircraft and automobiles

Apr. 5: Trump instructs USTR to consider $100 bill. of additional tariffs on China

Apr. 6: China announces “the nation will follow suit to the end and at any cost”

Apr. 18: China places 179% tariff on U.S. sorghum imports
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 – 9 million acres of soybeans (Wally Tyner, Purdue University)
U.S. Soybean Exports to China
Soybean Prices - $/bu.

Brazil Port
Central Ohio
Gulf

23%
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:

\[ Y = C + I + G + (X - M) \]

◊ 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

U.S. Current Account 1980-2017
(millions of $)

Source: U.S. Census Bureau

- Goods and Services
- Goods Only
Savings and the Trade Deficit

- Savings: \( S = (Y - T - C) + (T - G) \rightarrow S = Y - C - G \)
  
  \( (X - M) = Y - (C + I + G) \rightarrow (S - I) \)

  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

Current account, net foreign wealth (billions of dollars)

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: 133 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.
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