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Why Current Trade Policy Will Not Solve the US Trade Deficit

Introduction

Recently, economists Aaditya Mattoo and Robert Staiger have argued that US trade policy has switched from one that is “rules-based” to one that is “power-based”.¹ Under this approach the Trump administration selects countries with whom it has significant bilateral trade deficits, as targets for aggressive bargaining through tariff threats. This focus is driven by the notion that bilateral trade should be balanced, and if a trading partner does run a trade surplus with the United States, it must be because it is not granting equal access. This is a dimension of seeing trade as a zero-sum game; countries running a trade surplus with the United States must be “winners” while the United States must be a “loser.” President Trump has frequently expressed this view, tweeting on April 4, 2018:

“We are not in trade war with China, that war was lost many years ago by the foolish, or incompetent people who represented the U.S. Now we have a Trade Deficit of \$500 Billion a year, with Intellectual Property Theft of another \$300 Billion. We cannot let this continue!”²

If this were simply the argument of an ill-informed politician, that would be one thing, but the president is receiving advice on how to deal with the US trade deficit from both

economist Peter Navarro, head of the White House National Trade Council, and Wilbur Ross, the Commerce Secretary, that is fundamentally flawed.³ During the presidential election, Navarro and Ross wrote a position paper on trade⁴ that, to quote one observer, “shows a mind-boggling misunderstanding of the effect of trade on GDP.”⁵ In addition, once in office, the president signed an executive order directing the Commerce Department and the United States Trade Representative (USTR) to assess what is driving the US trade deficit, with a focus on the extent to which countries with a bilateral surplus with the United States are acting unfairly.⁶ The corollary of this is that a US trade policy pushing trade partners, in bilateral negotiations, to reduce their trade surpluses with the United States will reduce the US trade deficit, and, at the same time, increase its GDP growth rate.⁷

¹ Aaditya Mattoo and Robert W. Staiger, *Trade wars: What do they mean? Why are they happening now? What are the costs?* NBER Working Paper, 25762 (Apr. 2019). <https://www.nber.org/papers/w25762>

² Donald Trump (@realDonaldTrump), TWITTER (Apr. 4, 2018 2:22 PM), <https://twitter.com/realdonaldtrump/status/981492087328792577?lang=en>

³ See David R. Henderson, *Trump’s trade trifecta will likely target China, Canada and beyond*, Fraser Institute (Jan. 9, 2017),

<https://www.fraserinstitute.org/blogs/trump-s-trade-trifecta-will-likely-target-china-canada-and-beyond>

⁴ See Peter Navarro and Wilbur Ross, *Scoring the Trump Economic Plan: Trade, Energy, and Policy Impacts* (2016), https://assets.donaldjtrump.com/Trump_Economic_Plan.pdf

⁵ See Henderson, *op. cit.*

⁶ See Caroline Freund, *Public Comment on Trump Administration Report on Significant Trade Deficits*, Peterson Institute for International Economics (May 8, 2017), <https://piie.com/blogs/trade-investment-policy-watch/public-comment-trump-administration-report-significant-trade>

⁷ See Robert Z. Lawrence, *Five Reasons Why the Focus on Trade Deficits is Misleading*, Peterson Institute of

Some Simple National Income Accounting

In order to illustrate why this policy conclusion is a fallacy, and why virtually all economists would disagree with it,⁸ it is necessary to outline some basic national income accounting relationships that can be used to show that the US trade deficit is a structural macroeconomic problem that will not be resolved through bilateral trade negotiations. Starting with the national income accounting identity for an open economy, this can be stated as:

$$Y = C+I+G+(X-M) \quad (1)$$

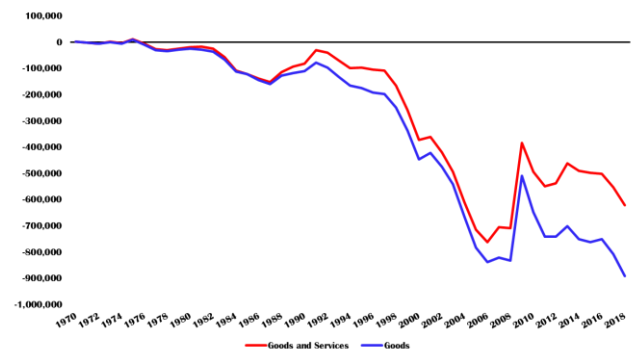
where Y is a country's GDP, the aggregate supply of goods and services; C+I+G is the value of aggregate demand for goods and services, made up of total household consumption of goods and services (C), the investment purchases by firms of goods and services (I), and government purchases of goods (G); and X and M are the value of total exports and imports of goods and services, (X-M) being a country's current account (CA).⁹ Technically, the current account consists of both the trade balance, (X-M) plus net income flows based on payments received from or paid to foreigners.¹⁰ However, due to the trade balance typically being the largest component of the current account, they are treated synonymously here for simplicity.

The national income accounting identity is an equality, that is, it is true regardless of the value of its variables. Therefore, it is very straightforward to dismiss the argument that reducing imports will increase a country's GDP as claimed by Peter Navarro and Wilbur Ross. More importantly though, this identity can be rearranged to show that the current account (X-M) is in surplus or deficit depending on the difference between the aggregate supply (Y) and aggregate demand (C+I+G) of goods and services, i.e.,

$$CA = (X-M) = Y-(C+I+G) \quad (2)$$

Essentially, if aggregate supply exceeds aggregate demand, a country will run a trade surplus. Conversely, if aggregate demand exceeds aggregate supply, a country will run a trade deficit. In the case of the United States, which has run a trade deficit since the early 1970s (see Figure 1), imports of goods and services make up the difference between what US residents supply and demand.¹¹ As of the end of 2018, the United States was running a record goods trade deficit of \$891 billion, and when adjusted for the US trade surplus in services, the headline deficit stood at \$621 billion.

Figure 1: US Trade Balance, 1970–2018



Source: US Census Bureau

Flows of Goods and Services to Financial Flows

This leads to a key question: what is the root cause of the US trade deficit? To answer this requires rewriting the national income accounting identity to highlight the connection between the flow of goods and services (C, I, G, X, and M) and financial flows.

Specifically, a country's national savings (S) are made up of private and public savings.¹² Private savings are defined as GDP net of taxes, i.e., tax payments less any transfer payments from the government, minus consumption (Y-T-C), while public savings are defined as the difference between government revenue generated through taxation, net of any transfer payments, and

International Economics, Policy Brief 18-6 (Mar. 2018), <https://piie.com/system/files/documents/pb18-6.pdf>

⁸ See C. Fred Bergsten, *Trade Balances and the NAFTA Renegotiation*, Peterson Institute of International Economics, Policy Brief 17-23 (June 2017), <https://piie.com/system/files/documents/pb17-23.pdf>

⁹ See Paul R. Krugman, Maurice Obstfeld, and Marc J. Melitz, *International Economics: Theory and Policy* (2012).

¹⁰ See Thomas A. Pugel, *International Economics*, (2007).

¹¹ See Krugman *et al.*, *op. cit.*

¹² See Krugman *et al.*, *op. cit.*

government spending (T-G), i.e., national savings can be denoted as:

$$S = (Y-T) - C + (T-G) \quad (3)$$

Assuming that the taxes deducted from income, are the same as the taxes levied by the government, then national savings can be defined as:

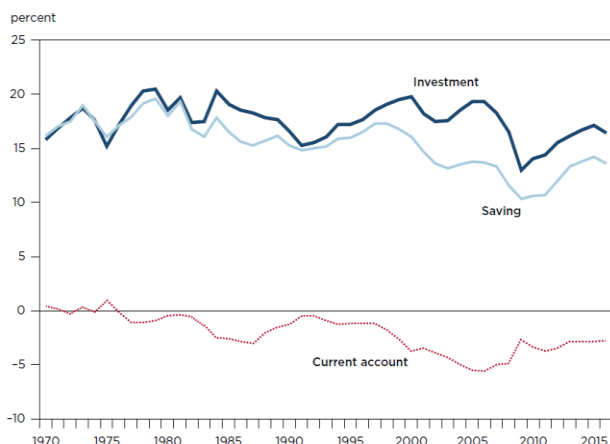
$$S=Y-C-G \quad (4)$$

The expression for national savings in (3) can then be used to rewrite the national income accounting identity (2) as:

$$CA=S-I \quad (5)$$

i.e., the current account is the difference between a country's savings and investment. Therefore, the underlying macroeconomic reason for the US trade deficit is due to the fact that the US supply of savings (S) is less than its demand for investment (I).¹³ In other words, as a nation, the United States does not save enough, a conclusion with which virtually all economists agree.¹⁴ Figure 2 clearly illustrates that since the 1980s, as a percentage of GDP, US investment has exceeded national savings, and at the same time the United States has consistently run a current account deficit.

Figure 2: US National Savings, Investment and Trade Balance, 1960–2010



Source: Bureau of Economic Analysis

The difference between national savings and investment is made up by net foreign investment, I^f , which is defined as the difference between capital outflows from and capital inflows to a country.¹⁵ If a country's financial claims on foreign residents and institutions exceed the foreign financial claims on that country's residents and institutions, its net foreign investment is positive; in the case of the United States, its net foreign investment is negative. This means that the United States is a net exporter of claims on financial assets at the same time as it is a net importer of goods and services.

Net foreign investment (I^f), can be divided two components: the capital account consisting of net private capital flows (KA), and flows of official reserve assets (OR), where official reserves are made up of central bank holdings of foreign currency and other securities.¹⁶ A country's balance of payments (B) is measured by the sum of the current and capital accounts:

$$B=CA+KA \quad (6)$$

As an accounting convention, B should equal zero.¹⁷ In other words, a negative current account should be balanced by a positive capital account. Therefore, any imbalance in the balance of payments B, must be financed through flows of official reserves,

$$B+OR = 0 \quad (7)$$

Given that the United States' trade deficit is a macroeconomic phenomenon, there are four interconnected questions relating to the deficit. First, if the US trade deficit is not a function of trade policy, what is its underlying cause? Second, is there an inevitability to the US running a trade deficit given that the US dollar is the international reserve currency? Third, should policymakers be concerned about the United States persistently running a trade deficit? Fourth, what are the appropriate policy instruments that could be targeted at reducing the US trade deficit?

¹³. See Krugman *et al.*, *op. cit.*

¹⁴. See Freund, *op. cit.*

¹⁵. See Bergsten, *op. cit.*

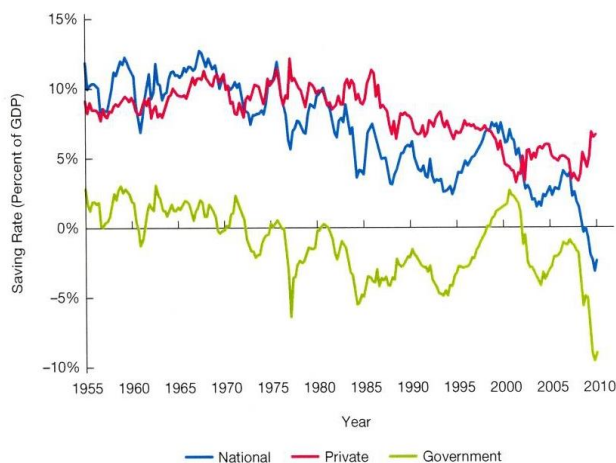
¹⁶. See Pugel, *op. cit.*

¹⁷. See Krugman *et al.*, *op. cit.*

Underlying Cause of the US Trade Deficit

In answer to the first question, most economists agree that the US trade deficit has grown over time due to a decline in the national savings rate, driven by declines in both private and public savings rates.¹⁸ In other words, US households have a high marginal propensity to consume and the US government has had a propensity to run fiscal deficits, as shown in Figure 3.

Figure 3: US Savings Rates, 1960–2010



Source: Bureau of Economic Analysis

Consequently, unless savings increase and/or investment falls, the US trade deficit will continue to grow. In particular, economists such as Jeffrey Frankel at Harvard have pointed out that the tax cuts and budget legislation passed in Congress in 2017 and trade policy supported by the Trump administration will increase the US fiscal deficit, which will feed into an increase in the current account deficit.¹⁹ This outcome will be exacerbated by the fact that the US economy is currently running at full employment, output being constrained by capacity.²⁰ Therefore, increased spending due to tax cuts will almost entirely go into imported goods and services thereby increasing the trade deficit.²¹

¹⁸. See Freund, *op. cit.*

¹⁹. See Jeffrey Frankel, *Donald Trump is making America's deficits great again*, *The Guardian* (Jan. 15, 2018), <https://www.theguardian.com/business/2018/jan/15/donald-trump-is-making-americas-deficits-great-again>

²⁰. See Frankel, *op. cit.*

²¹. See Frankel, *op. cit.*

The US Dollar as the International Reserve Currency

One possible explanation put forward for the long-running US trade deficit is associated with the collapse of the Bretton Woods System in 1971, and the so-called "Triffin dilemma" which predicts that with the dollar becoming the international reserve currency, the US must run a persistent current account deficit.²²

The Bretton Woods system, which was established in response to the failure to coordinate exchange rates during the inter-war period, began operating in December 1958. This system of monetary and exchange rate management was based on: (1) the US dollar becoming an international reserve currency, (2) member countries fixing the value of their currency in terms of the US dollar, and defending that exchange rate through intervention in the foreign exchange market, and (3) the US dollar being backed by gold at a price of \$35 per ounce. Despite facilitating and stabilizing global trade, President Nixon broke the US dollar's peg to gold in 1971, effectively ending the Bretton Woods System.

The end of this system came about as other countries running trade surpluses with the US, sought to exchange dollars for gold. As a result, the Bretton Woods System became a gold-dollar system, i.e., the global stock of gold was insufficient to finance growth of the world economy, the gap being filled by dollars, the US accumulating short-term dollar liabilities to the rest of the world.²³ In turn, this generated the risk that the US would not be able to meet its obligation to redeem dollars at the official price of gold.²⁴

The idea that increasing use of the dollar as official reserves would inevitably lead to a run on the US's holdings of gold was predicted by

²². See Brian Reinbold and Yi We, *Understanding the Roots of the U.S. Trade Deficit*, Regional Economist, Federal Reserve Bank of St. Louis (Third Quarter, 2018), <https://www.stlouisfed.org/publications/regional-economist/third-quarter-2018/understanding-roots-trade-deficit>

²³. See Michael D. Bordo and Robert N. McCauley, *Triffin: dilemma or myth?* Bank for International Settlements, Working paper 684 (Dec. 2017), <https://www.bis.org/publ/work684.pdf>

²⁴. See Reinbold and We, *op. cit.*

the economist Robert Triffin.²⁵ More importantly his ideas have been adapted to a world where the dollar is the global currency and the US a supplier of safe assets in the form of US treasuries.

Triffin's original argument concerned the capital account, i.e., the US would accumulate a stock of dollar-denominated liabilities that would eventually be greater than the value of its stock of gold. The modern application of his argument focuses instead on the current account: essentially, if the dollar is the global currency, the US is required to run a current account deficit. If world GDP increases faster than US GDP, the demand for dollar reserves increases, thereby raising US external debt. Consequently, there are two potential outcomes: either the US does not run a current account deficit leading to a shortage of global reserves or US external debt rises continuously, thereby undermining the value of the dollar and hence the value of dollar reserves.²⁶

This version of the Triffin dilemma does raise two questions. First, do countries actually seek to accumulate dollar reserves as a means of insuring themselves against a liquidity crisis, or are they a simply a by-product of their running current account surpluses? The latter argument is quite convincing when looking at how successive emerging economies such as China have run current account surpluses as a part of their growth strategy. In other words, the persistent US current account deficit has nothing to do with the dollar *per se*, but is more a function of the policy choices of other economies and the size of the US.²⁷

Second, are there really parallels between the Bretton Woods system and what has followed in terms of systemic breakdown? Under Bretton Woods, there was a clear cross-over point where claims on the US would outweigh its stock of gold, and so the breakdown of the system was entirely possible. Post-Bretton Woods it is unclear when US indebtedness actually becomes a problem. As discussed in the next section, macroeconomists do worry about the implications of the US current account deficit being unsustainable, with the

²⁵ See Bordo and McCauley, *op. cit.*

²⁶ See Bordo and McCauley, *op. cit.*

²⁷ See Bordo and McCauley, *op. cit.*

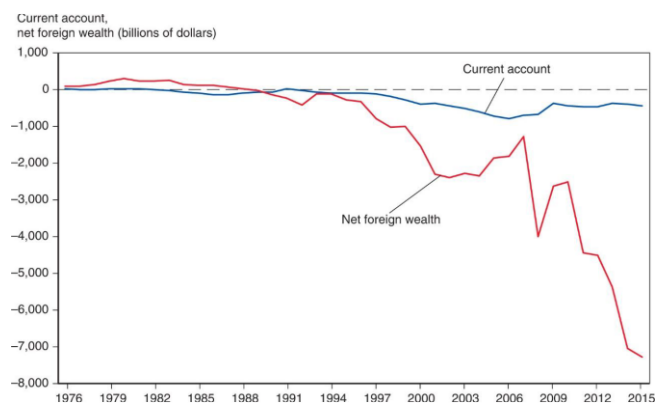
potential for a hard landing. However, this is not the same as the system breakdown predicted by Triffin. The latter would likely only happen if the US defaulted on its debt.²⁸

Should We Be Concerned?

In thinking about the third question, while the administration focuses its concern on the fact that the United States currently runs bilateral trade deficits with countries such as China, Germany, and Japan, economists argue that these are of little or no concern.²⁹ In fact, the focus on say the bilateral trade deficit with Japan is entirely misplaced, due to the fact that reducing that deficit is very unlikely to significantly reduce the overall US trade deficit.³⁰ In other words, unless the underlying macroeconomic fundamentals change, any reduction in the US trade deficit with Japan will simply be replaced by an increase in the deficit with other countries.

What matters is that in order to facilitate its aggregate current account deficit, the United States continues to run a negative and growing net international investment position (NIIP), as shown in Figure 4.³¹

Figure 4: US Current Account and Net International Investment Position, 1976–2015



Source: Bureau of Economic Analysis

²⁸ See Bordo and McCauley, *op. cit.*

²⁹ See Freund, *op. cit.*

³⁰ See Bergsten, *op. cit.*

³¹ See Joseph E. Gagnon, *The Unsustainable Trajectory of US International Debt*, Peterson Institute of International Economics (Mar. 29, 2017), <https://piie.com/blogs/realtime-economic-issues-watch/unsustainable-trajectory-us-international-debt>

At the end of 2016, foreign financial claims on the United States exceeded US financial claims on other countries by \$8.4 trillion, NNIP being –45 percent of GDP, and forecast to increase to –53 percent of GDP by 2021.³² Economists such as Maurice Obstfeld and Kenneth Rogoff, current and former chief economists at the International Monetary Fund (IMF), have argued that this is not sustainable, and would require a significant real depreciation of the US dollar and higher long-term bond yields, along with associated adjustment costs in terms of unemployment. Also, the longer the trade deficit continues, the more extreme relative price adjustments will have to be.³³ In 2000, Obstfeld and Rogoff forecast that elimination of the trade deficit would require the dollar to depreciate by 13 percent in real terms, but by 2005 they had raised this to 33 percent.³⁴

Economists, with almost no exceptions, are in agreement that trade policy will not solve the US trade deficit/international debt problem.³⁵ The empirical evidence suggests that trade policy has little effect on a country's trade balance—average tariffs are negatively correlated with trade balances, and liberalizing trade has little impact on those balances.³⁶ More restrictive trade policy, such as higher tariffs, will therefore have only a marginal effect, if any, on the US trade deficit.³⁷ While tariffs do reduce imports, they will also reduce exports, which follows from the fact that import tariffs reduce the demand for foreign currency, thereby strengthening the US dollar, which then feeds into lower exports.³⁸

How to Reduce the US Trade Deficit?

Many economists believe two interdependent policy choices need to be made in order to target the underlying macroeconomic cause of the US trade deficit: a managed real depreciation of the US dollar in combination with policies designed to increase national

savings.³⁹ Joseph Gagnon and Fred Bergsten of the Peterson Institute for International Economics have argued that the United States should announce a policy of “countervailing currency intervention” to offset any currency intervention by G20 countries that are running trade surpluses.⁴⁰ At the same time, the gap between US savings and investment should be reduced by cutting the fiscal deficit.⁴¹ Without the latter, there is a potential for overheating in the US economy as inflation increases with dollar depreciation, resulting in the Federal Reserve raising interest rates.⁴² The latter would encourage more savings and less investment, but at the same time put upward pressure on the dollar as US financial assets become more attractive to overseas lenders.⁴³ Therefore, reducing the fiscal deficit will result in lower interest rates, which will in turn help with currency depreciation.

Conclusion

As outlined here, these policy choices are matters of macroeconomic policy, and not trade policy, such as higher tariffs. Indeed, there is little debate among economists on this point.⁴⁴ The hurdle to implementing such changes has been a political one because a number of these specific policy choices, such as taxing consumption and increasing public saving through higher taxes and/or lower government spending, are highly unpopular with the American electorate.⁴⁵ Thus, a significant practical issue has been the lack of political will on the part of elected US government officials who are reluctant to propose and implement unpopular policy

³². See Gagnon, *op. cit.*

³³. See Maurice Obstfeld and Kenneth Rogoff, *Global Current Account Imbalances and Exchange Rate Adjustments*, Brookings: Papers on Economic Activity (1, 2005).

³⁴. See Obstfeld and Rogoff, *op. cit.*

³⁵. See Freund, *op. cit.*

³⁶. See Freund, *op. cit.*

³⁷. See Freund, *op. cit.*

³⁸. See Freund, *op. cit.*

³⁹. See Joseph E. Gagnon, *Curbing the Growth of US International Debt*, Peterson Institute of International Economics (Mar. 29, 2017),

<https://piie.com/blogs/realtime-economic-issues-watch/curbing-growth-us-international-debt>

⁴⁰. See Gagnon, *op. cit.*

⁴¹. See Gagnon, *op. cit.*

⁴². See Gagnon, *op. cit.*

⁴³. See Gagnon, *op. cit.*

⁴⁴. See Freund, *op. cit.*

⁴⁵. See *Fewer Want Spending to Grow, But Most Cuts Remain Unpopular*, Pew Research Center (Feb. 10, 2011),

<http://www.people-press.org/2011/02/10/fewer-want-spending-to-grow-but-most-cuts-remain-unpopular/>

See also, John Gramlich, *Few Americans Support Cuts to Most Government Programs, Including Medicaid*, Pew research Center (May 26, 2017),

<http://www.pewresearch.org/fact-tank/2017/05/26/few-americans-support-cuts-to-most-government-programs-including-medicaid>

changes for fear of stoking the ire of their constituencies.⁴⁶

Andersons Policy Bulletins are discussions of key trade and policy issues. The author of this bulletin, Ian M. Sheldon, is Andersons Chair of Agricultural Marketing, Trade and Policy in the Department of Agricultural, Environmental, and Development Economics within the College of Food, Agricultural, and Environmental Sciences at The Ohio State University.

Questions or comments?

e-mail: sheldon.1@osu.edu

web-page:

<https://aede.osu.edu/research/andersons-program>

⁴⁶. See Eduardo Porter, *America's Aversion to Taxes*, *New York Times* (Aug. 14, 2012), <https://www.nytimes.com/2012/08/15/business/economy/slipping-behind-because-of-an-aversion-to-taxes.html>