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PUBLIC INTEREST COMMENT

EFFORTS TO REDUCE THE TRADE DEFICIT WILL HAVE UNINTENDED NEGATIVE CONSEQUENCES

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Administration Report on Significant Trade Deficits
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INTRODUCTION

In a March 31, 2017, executive order, President Trump directed that his administration undertake an "Omnibus Report on Significant Trade Deficits." The order identified a number of potential causes of trade deficits, including differential tariffs, nontariff barriers, intellectual property theft, and other factors.[1] In assessing why the residents of the United States run a

1. Office of the Press Secretary, "Presidential Executive Order Regarding the Omnibus Report on Significant Trade Deficits," March 31, 2017.

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trade deficit with individual countries and with the rest of the world, the Trump administration should give serious consideration to the "other factors contributing to the deficit."

This comment will seek to explain that the US trade deficit is not driven by the specific trade factors listed in the executive order, but by the difference between the levels of national investment and national savings in the US economy. It will explain why seeking to reduce the overall deficit and individual bilateral deficits through trade policy will cause unintended and negative consequences for US consumers, companies, and workers.

US TRADE DEFICIT IS DRIVEN BY THE INVESTMENT–SAVINGS GAP

According to the national income accounting identity,[2] the difference between what the United States exports and imports in a given year must equal the difference between national savings and national investment.[3] Therefore, the United States runs a deficit on the current account year after year for one reason: gross domestic investment in the economy exceeds gross domestic savings.

If a nation's residents save more than the total amount that is invested in the domestic economy, net exports will be positive—that is, the nation's residents will export more than they import. If total domestic investment exceeds domestic savings, net exports will be negative—that is, the nation's residents will import more than they export.

The US current account has run an annual deficit for the past four decades for the basic reason that investment opportunities—and the amount of investment in these opportunities—have been consistently higher each year than the gross amount saved by Americans. The gap is filled by an annual net inflow of foreign capital, which mirrors and offsets the trade deficit. From 2010 to 2015, gross investment in the United States as a percentage of GDP averaged 19.4 percent of US gross domestic product, while gross savings averaged 17.5 percent, according to the Bureau of Economic Analysis.[4] The result has been a persistent deficit in the current account.

POLICY MUST ADDRESS SAVINGS AND INVESTMENT LEVELS

The lesson for policymakers is that the current account balance can only be altered if there is a change in the level of either gross domestic savings or gross domestic investment, or if there are changes in both categories. If policymakers are determined to eliminate the trade deficit, they need to pursue policies that would increase the pool of domestic savings, discourage investment in the domestic economy, or both. Gross savings can be increased either in the private sectors (i.e., household and corporate) or in the public sector—in the latter most obviously by reducing the federal budget deficit.

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2. GDP = consumption + investment + government spending + (exports − imports).
3. Daniel Griswold, "Plumbing America's Balance of Trade" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2017), 13–17.
4. Bureau of Economic Analysis, "National Economic Accounts," Personal Income and Outlays, Interactive Tables: National Income and Product Accounts Tables, Table 5.1.

Any federal policy program to reduce the trade deficit that does not close the current gap between national investment and national savings would be doomed to fail. It would also increase the risk of disrupting other channels of commerce between American residents and the rest of the world that are beneficial to the US economy.

DECREASING BILATERAL TRADE DEFICITS WOULD REDIRECT TRADE

If the US government were to attempt to shrink or eliminate its bilateral deficit with a particular country to reduce the overall trade deficit—but do so without changing the underlying balance of savings and investment—the effort would also fail. America could try to badger another country into buying more US exports, or it could block that country's imports with tariffs. Either action might shrink the bilateral deficit, but without a change in the underlying macroeconomic factors that determine the overall balance, such actions would simply reallocate the balance among America's other trading partners.

Because the trade deficit is the flip side of the capital account surplus, the size of the trade deficit is determined by underlying macroeconomic causes and differential investment opportunities across countries. Any government intervention to boost exports or restrict imports will necessarily affect the flow of dollars for other transactions, such as cross-border investment, thus putting US employment and production at risk. If the policy were to succeed at reducing the cumulative trade deficits with the targeted trading partners, the cumulative balance with nontargeted countries could be expected to increase by the same amount, offsetting any change in the overall balance.

MULTILATERAL BALANCE WOULD BE MINIMALLY AFFECTED

By forcing adjustments elsewhere, intervention could have a disruptive effect on trade, international patterns of specialization, and investment flows, thus reducing US economic growth. Such a disruption would mean fewer dollars flowing out to pay for imported goods and services from the targeted countries and more dollars flowing in from the same countries to buy exported US goods and services. Both changes would have the effect of draining dollars from global currency markets, resulting in a stronger dollar because the supply of dollars for other transactions would be constricted.

An appreciating dollar, in turn, would dampen demand for US exports in other countries while stimulating demand for imports in the United States. Increased exports to the targeted countries would be offset by fewer exports to the rest of the world. A stronger dollar would mean certain American manufacturers would export fewer civilian aircraft, motor vehicles, industrial machines, pharmaceuticals, plastics, and chemicals.[5]

An appreciated dollar would also discourage tourism to the United States, as well as the sale of intellectual property and consulting services. The same changes in the exchange rate would

5. US Census Bureau, "Foreign Trade: Country and Product Trade Data," Product Detail and Partner Country: North American Industry Classification System (NAICS)-Based, End-Use: US Exports to World Total by 5-Digit End-Use Code, 2006–2015, https://www.census.gov/foreign-trade/statistics/country/index.html.

stimulate the import of such goods as crude oil, motor vehicles, cell phones, computers, and clothing.[6] The result of an appreciated dollar may in fact be good for American households and the US economy, but it would mute any changes in the overall trade deficit.

NEGATIVE EFFECTS OF CLOSING THE TRADE DEFICIT

If critics of the trade deficit actually succeeded in closing or eliminating it, despite the appreciating dollar, the result would be to reduce the amount of investment funds flowing into the United States. If the trade deficit were eliminated, foreign demand for US bonds and Treasury bills would fall, pushing up interest rates. Home mortgage rates would go up, making housing less affordable for working Americans. The interest rate that the federal government pays on its debt would increase, costing the federal government tens of billions of dollars more to finance its debt at a time when the government is expected to be borrowing even more for infrastructure projects. As for equity markets, reducing non-Americans' investments in corporate stocks would lower share prices.[7]

The increased cost of acquiring dollars would also make it more expensive for foreign-owned businesses to create or expand affiliates in the United States, which, in turn, would dampen job creation by such firms. The number of Americans that those affiliates now employ (currently 6.4 million[8]) would be less likely to increase and could even decrease as foreign multinational companies could seek better investment opportunities elsewhere. Fewer dollars flowing into US bank deposits would reduce the amount of capital that banks are able to lend for domestic investment.

CONCLUSION

The proper focus of US trade policy should not be to impose a misconceived theory of "balanced" trade on residents of the United States and American trading partners. Trade policies aimed at reducing the trade deficit will have the negative effect of depriving Americans of the freedom to trade goods and services in the global market to maximum advantage. Such policies would also interfere with the freedom to trade investment assets across international borders, depriving Americans of the benefits of both inward and outward investment. The aim of US trade policy should not be the reduction of the trade deficit, but the promotion of greater freedom for Americans to buy, sell, and invest in the global economy.

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6. Ibid.
7. For a more detailed analysis of the economic benefits of a net capital inflow to the United States, see Griswold, "Plumbing America's Balance of Trade," 13–17.
8. Ibid., 17.