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POLICY BRIEF

18-6 Five Reasons Why the Focus on Trade Deficits Is Misleading

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In his criticism of trade agreements and policies that have guided his predecessors over many decades, President Donald Trump has asserted that trade balances are a key measure of a nation's commercial success and that large US trade deficits prove that past trade approaches have been flawed. "The jobs and wealth have been stripped from our country year after year, decade after decade, trade deficit upon trade deficit,"[1] he has said. Using the trade deficit between the United States and Mexico as a metric, the president called the North American Free Trade Agreement (NAFTA) "the worst trade deal ever"[2] and excoriated the Korea-US Free Trade agreement (KORUS) on similar grounds. He has told the Chinese president Xi Jinping that America's large trade deficit with China was "not sustainable."

Trump also argues that the United States has signed bad trade agreements that have opened the US market and encouraged US firms to move offshore while allowing foreigners to maintain high trade barriers and engage in unfair trade practices. According to him, this deeply flawed approach has resulted in the loss of millions of US manufacturing jobs due to offshoring and imports flooding the US market.

Accordingly, the president and his trade advisors believe that the aim of US trade policy should be to reduce these trade deficits and, ideally, turn them into surpluses. In pursuit of that objective, the administration has canceled American participation in the Trans-Pacific Partnership (TPP), demanded a renegotiation of NAFTA and KORUS, while raising tariffs to protect US industries that produce washing machines, solar panels, aluminum, and steel. Additionally, the administration has launched a campaign against the dispute settlement system of the World Trade Organization (WTO), claiming that it is has failed to deal with the unfair trade practices of countries such as China.

But trade deficits are not in fact a good measure of how well a country is doing with respect to its trade policies. Many of the assumptions on which the administration's beliefs rest are not supported by the evidence. This Policy Brief argues that trade deficits are not necessarily bad, do not necessarily cost jobs or reduce growth, and are not a measure of whether foreign trade policies or agreements with other countries are fair or unfair. Efforts to use trade policy and agreements to reduce either bilateral or overall trade deficits are also unlikely to produce the effects the administration claims they will. Such efforts could prove counterproductive and lead to friction with US trading partners, harming the people the policies claim to help. The United States benefits both from importing and from exporting; to raise US living standards, therefore, trade policies should aim to reduce trade and investment barriers at home and open markets for US products abroad.

In its criticism of past trade policies, the administration has cited the $752.5 billion deficit in goods in 2016, which was 4 percent of GDP. But this focus on trade in goods alone is too narrow. This Brief uses the broader definition

1. Quoted by Eduardo Porter, *New York Times*, October 17, 2017.

2. In 2016 the US trade deficit with Mexico was $70.5 billion and $63 billion for goods and goods and services, respectively.

of the trade balance that includes trade in *services*—financial services, tourism, consulting, and the like—which makes up more than a third of US trade. Trade in services also provides employment, generates US income, and enhances US welfare. The United States had a $247.7 billion surplus in services trade in 2016, bringing the total trade deficit in goods and services down to about $500 billion. In assessing trade balances, it is more appropriate to consider goods, services, and indeed the net earnings of Americans from investing and working abroad. This Policy Brief will therefore focus on the trade balance that includes all these elements and that is more commonly defined as the current account, which was 2.4 percent of US GDP in 2016.

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MISCONCEPTION 1: TRADE DEFICITS ARE BAD

Are trade deficits good or bad? They could be either. Although people often characterize movement towards a larger trade deficit as "worsening," this terminology is flawed. There are two ways to look at the trade deficit. The most straightforward is as the difference between exports and imports. The Trump view is basically that exports are good—they are like revenues—and imports are bad—they are like costs. And the size of the surplus is like the score in an international competition. Thus, in this view, the bigger the difference between exports and imports, the more beneficial the trade, and as Trump has asserted, trade wars are easy to win,[3] because all the nation needs to do is reduce imports. But this view reflects a failure to appreciate that both imports and exports are beneficial. On the one hand, by buying goods and services more cheaply than it costs to produce them at home, the nation benefits from imports; and on the other hand, by selling goods and services in world markets, it can enjoy higher prices for them than it could earn by selling only at home. Thus, a trade deficit that is associated with large volumes of both imports and exports could actually be more beneficial than a trade surplus in which trade volumes are low. And reducing imports could prove very costly.

A second way to understand trade deficits is to recognize that they reflect the fact that the United States is borrowing from the rest of the world, and as with all borrowing, determining whether the borrowing is good or bad all depends on what you do with the money. If the United States as a whole spends more on imports than it earns from exports, it will need to borrow from the rest of the world to make up the difference. Conversely, running trade surpluses means accumulating claims on the rest of the world.[4] This means that the trade balance reflects not only what is happening in the markets for exports and imports but simultaneously the net international flows of capital that are used to make up the difference between national saving and national investment. In a closed economy, if participants wish to invest in plant and equipment, they have to rely on their own savings to fully finance the investment. But an open economy can also obtain savings from abroad and thus invest more than domestic savings by running a trade deficit and borrowing from the rest of the world. Alternatively, it can lend to the rest of the world by running a trade surplus and thus saving more than it invests at home.

The perspective that trade balances reflect the difference between national saving and investment can help determine whether trade deficits are good or bad. A deficit could be undesirable if it indicates borrowing for spending on consumption rather than investment and if it occurs in amounts that are unsustainable and likely to lead to a crisis. But a deficit could also enhance societal welfare if the borrowing is used to finance productive investments that will eventually help the economy to repay the money with a profit. Similarly, a surplus could be desirable if it generates higher returns than are available on domestic investments but could be undesirable if it comes at the expense of needed domestic production and investments. All told, without identifying the causes of the trade balance, we cannot say if it is good or bad.

MISCONCEPTION 2: TRADE BALANCES REFLECT TRADE POLICIES

President Trump blames US trade policies for America's trade deficits, and his administration believes that new trade policies and agreements that increase specific exports or protect particular industries at home will boost the trade balance. The head of the White House National Trade Council, Peter Navarro, has claimed that reducing a trade deficit through "tough, smart negotiations" is the way to increase net exports.[5] But, surprisingly perhaps, most economists would not place trade policies high on the list of why countries run trade deficits or surpluses over long periods of time. For trade agreements to affect net exports, they must necessarily either increase total US saving and/or reduce overall US investment. While trade policies can play an important role in increasing

3. Trump tweets: 'Trade wars are good, and easy to win'," Reuters, March 2, 2018.

4. Deficits could also reflect reductions in net foreign assets, and surpluses could involve repaying foreign debts.

5. Peter Navarro, "Why the White House Worries About Trade Deficits," *Wall Street Journal*, March 6, 2017.

the volume of trade, it is not sufficient to argue that trade negotiations and other trade policies will affect trade flows but also necessary to explain how they will change saving and investment.

Over the long run, however, the influence of trade policies on the trade balance is likely to be overshadowed by the more fundamental determinants of saving and investment.[6] These more fundamental determinants include income, wealth, demographics, and expected future income and interest rates in the case of private saving; tax revenues and government spending in the case of government saving; and expectations about future profits and the costs of borrowing in the case of investment. However, the administration's trade narrative ignores the role of US private and public saving and investment in driving trade deficits in the past and fails to take account of the likely impact of its own tax and spending policies on the trade balance in the future.

Over the long run, the influence of trade policies on the trade balance is likely to be overshadowed by the more fundamental determinants of saving and investment.

Would a high trade barrier in a foreign market affect the US trade balance? Consider for example what happens when an unfair foreign competitor imposes a restrictive quota on imports of sugar. If binding, the quota could certainly reduce the quantity of sugar imported, but if foreign residents do not alter their saving or investment behavior—and it is not obvious why a sugar quota would induce such a change—in the long run the foreign country's trade balance would not be affected.[7] Rather than a smaller overall trade deficit, with no change in saving and investment, the quota would result in larger deficits in other components of the trade balance. One mechanism by which this would operate is through the exchange rate. If the country imports less sugar, its demand for foreign currency is likely to be reduced. This, in turn, is likely to strengthen its exchange rate, thereby making its exports more expensive in foreign markets and other imports relatively cheap at home. Therefore, in addition to reducing sugar imports, the quota could also reduce exports and increase its imports of other products.

While this example examines a trade restriction on just one product, it would still apply if, as the administration claims, foreigners adopted many such restrictions. As this example illustrates, while foreign trade policies such as domestic protection and export subsidies may well change the composition of US exports and imports unless saving and investment are altered, the potential impact on the trade balance is likely to be offset by changes in relative prices and exchange rates.

Nonetheless, the possibility that trade policies could affect the trade balance should not be totally ruled out, especially in the short run. If an economy has high levels of unemployment, for example, trade policies that increase exports or reduce imports *can* increase domestic employment and income. As long as this increased income boosts saving by more than it boosts investment, net exports could rise. But this is not a channel that would operate if the economy is at full employment—as is probably currently the case with the United States—and thus unable to meet the increased demand for exports or replace imports with additional domestic production. It is similarly possible that the trade balance could increase because of trade policy if the revenues from higher tariffs are saved or if trade policies or weaker exchange rates increase the profits and thus the savings of domestic firms by more than they stimulate investment.[8]

While the chain of causation that runs from the determinants of trade to saving and investment need to be considered, therefore, over the long run, saving and investment are more likely to reflect more fundamental determinants of spending than trade policies. In the case of the United States, determinants of spending have played an important role in trade deficits.

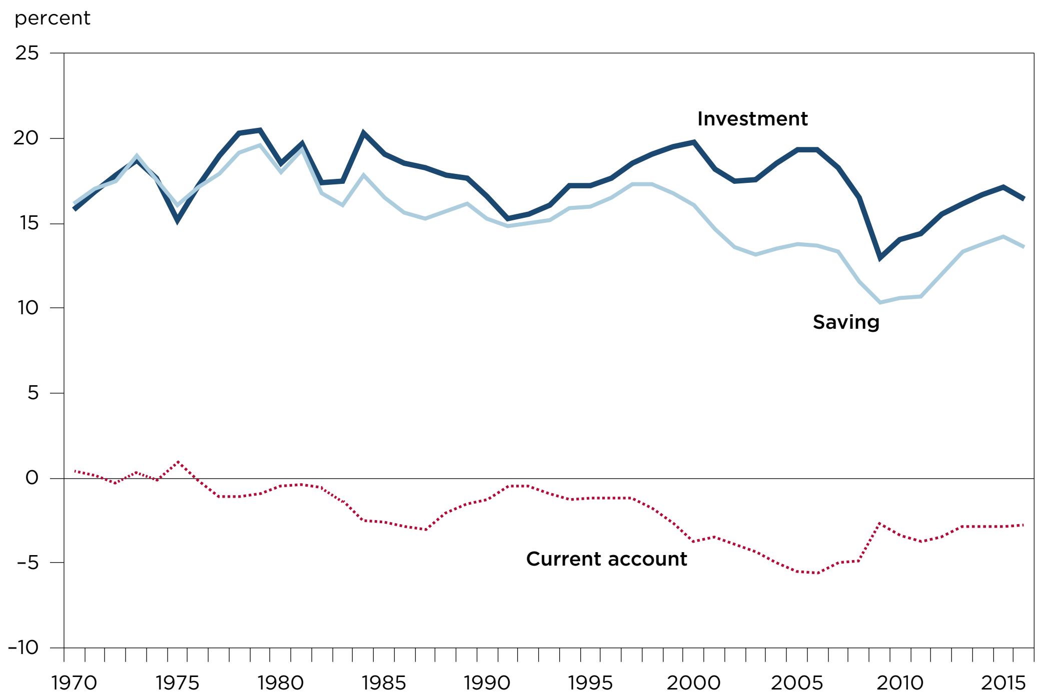
Figure 1 presents the data for US investment and saving and their difference (the trade balance, or current account) over the period 1970 to 2016. It shows that since the early 1970s, US domestic investment has been greater than domestic saving, and as a result the trade balance has been in deficit. In part fluctuations in the trade balance have reflected fluctuations in US investment, with net exports increasing and investment slumping in the recessions in the early 1980s, the early 2000s, and the financial crisis of 2008. But overall, investment has remained between 15 and 20 percent of GDP. By contrast, between 1982 and the financial crisis in 2008, while domestic saving has also fluctuated, it had a strong downward trend. In part the national saving declines resulted from the large federal budget deficits asso-

6. For more on the theory of why trade policies are unlikely to change the long-run trade balance, see Mankiw 2017, chapter 6.

7. Indeed, if the quota actually increased investment in the sugar industry, it could lead to larger rather than smaller trade deficits.

8. For a comprehensive survey of the current account from an intertemporal view, see Obstfeld and Rogoff (1995).

Figure 1 US current account balance, gross saving, and gross investment as a share of GDP: 1970–2016



Source: Table 1.1.10 US National Income Accounts, Bureau of Economic Analysis.

ciated with the tax cuts during the Reagan and the second Bush administrations and the budget deficits brought about by the financial crisis. While such policies have clearly had a major impact on the US trade balance, they surely have little to do with unfair foreign trade practices. In addition, the deficits reflect the long-run decline in the saving of US households from around 10 percent of GDP in the 1970s to around 5 percent in the mid-2000s—again, behavior that has little to do with US trade agreements.[9] All told, therefore, a host of developments that cannot be ascribed to US trade policies have had powerful impacts on the US trade balance.

In an economy close to or at full employment, negotiating new trade agreements is thus unlikely to increase net exports in the absence of other policies that increase US saving and/or reduce US investment. While the administration is trying to reduce the US trade deficit through its trade policies, it is especially ironic that rather than implementing policies that would increase private or public saving, the administration's other policies are likely to lead to larger trade deficits. These include tax cuts that are likely to reduce government saving and increase corporate and infrastructure investment. Unless American households become thriftier or the government runs smaller budget deficits, the United States could be better off borrowing from the rest of the world to fund profitable domestic investments, rather than run smaller trade deficits that require forgoing these opportunities.

This reasoning is particular relevant in the case of the current policy of renegotiating NAFTA to increase net exports. Peter Navarro has claimed that if America successfully negotiates bilateral trade deals these would reduce the overall US trade deficit, but he offers no explanation for how such negotiations would increase US saving or *reduce* US investment. Trying to reduce the aggregate trade deficit by reducing bilateral trade deficits without changing saving and investment is like squeezing the air in one part of a balloon. While the squeezing could create a dent in one place, it would simply redistribute the air to other parts of the balloon. If the United States maintains the same level of saving and investment, by definition the trade balance will not change.

The administration is seeking to renegotiate NAFTA because in 2016 the United States ran a $63 billion deficit in its trade with Mexico.[10] But suppose a new agreement could actually achieve balanced trade with Mexico. With no increase in US saving or decrease in domestic investment, buying fewer goods and services from Mexico will simply

9. For a comprehensive analysis of the decline in US saving see Bosworth (2012).

10. Bureau of Economic Analysis, https://bea.gov/international/index.htm (accessed March 8, 2018).

mean buying more goods and services from other trading partners. Similarly, with the US economy at full employment, selling more good and services to Mexico will simply mean selling fewer goods and services to the rest of the world. Moreover, if by discouraging offshoring, the new agreement actually increased investment in the United States as the administration claims it would, the result would be a larger rather than a smaller current account deficit.

Moreover, while renegotiating NAFTA is unlikely to affect the overall US trade balance in the long run, it could be very disruptive and cause considerable dislocation and job loss in the short run. It is well known that a tax on imported inputs can reduce exports. For example, placing tariffs on imported fabric will make clothing exports more expensive. As research by the Organization for Economic Cooperation and Development (OECD) and the WTO has underscored, products are "made in the world" using global value chains rather than manufactured entirely in just one country. Complex supply chains have evolved in North America between the United States and Mexico in products such as automobiles, aircraft, electronics, and clothing, with components often crossing the border many times as value is added in the production process. Indeed, over 60 percent of US merchandise imports are capital goods or components and parts rather than finished goods. New barriers to trade as advocated by the administration could therefore disrupt production and reduce rather than increase domestic employment in both the protected industries and those that use its outputs. The result could therefore be more rather than fewer US manufacturing workers losing their jobs.

MISCONCEPTION 3: TRADE DEFICITS ALWAYS LEAD TO JOB LOSS AND SLOWER GROWTH

Navarro has also claimed that an increase in net exports will by definition increase US growth.[11] But trade balances are outcomes—or what economists call endogenous variables—not causes. Outcomes can occur for a variety of reasons, and without identifying these basic reasons, it is impossible to infer what trade balances mean for either employment or growth.

Without knowing why imports are growing, for example, it is impossible to know the impact on domestic production and employment. Imports could increase (and net exports could decline) either because (a) there is an increase in domestic income, thereby increasing demand all round; or (b) the price of foreign products falls relative to domestic products. But these two example causes for increased imports will affect employment very differently. If the cause is higher domestic income, there will be more spending on both domestic and foreign products, and thus increased imports and a larger trade deficit will be positively associated with employment and growth. However, if the cause is a decline in the price of imported products relative to domestic products, increased imports *could* lead to fewer sales of domestic products, slower growth, and a decline in domestic employment.

The automatic links between trade deficits, job loss, and slow growth presumed by Navarro are certainly not evident in the data. Figure 2 suggests that changes in income in the United States have dominated import growth, and so the association between imports and total domestic employment has been overwhelmingly positive. Similarly, figure 3 shows that, especially before 2009, smaller trade balances (i.e. larger deficits) were associated with faster US economic growth. While in theory the relationship between imports, trade deficits, and employment and growth could be positive or negative, in practice rapid import growth and larger trade deficits have generally been associated with faster employment growth and larger GDP gains in the United States.

As this discussion suggests, careful estimates of the impact of trade on employment should separate changes in import growth attributable to improved foreign competitiveness from changes due to increased domestic spending and production. It is however common practice for some analysts to simply add the domestic employment content of exports and subtract the domestic employment equivalence of imports. This faulty method has been used to estimate jobs lost and gained as a result of both the aggregate trade balance and bilateral balances with individual trading (see Scott 2017).

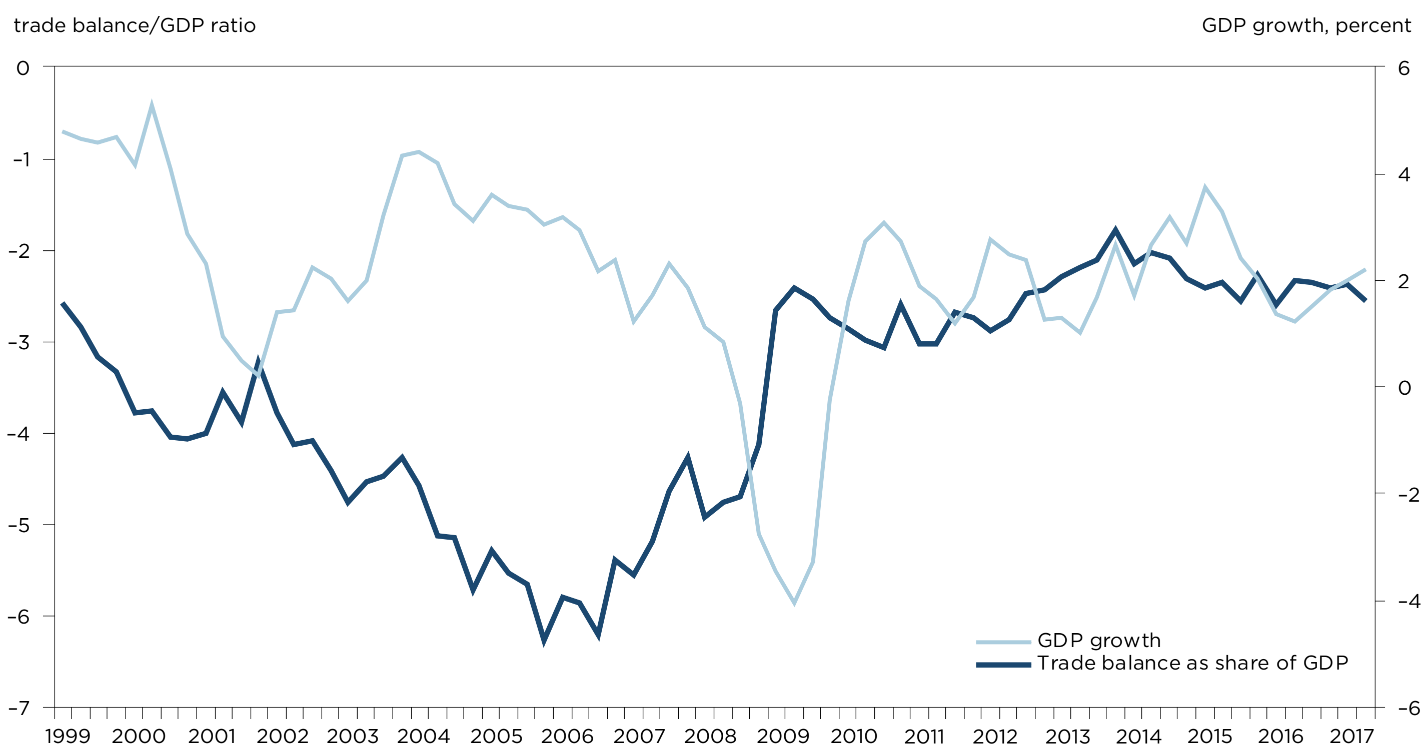
But these calculations can be highly misleading. For example, the United States currently has a trade deficit of over $500 billion. Yet as evidenced by the fact that the Federal Reserve is raising US interest rates, even taking discouraged workers into account, the economy is viewed as close to full employment. If this is the case, it is actually not possible to replace the deficit with domestic production, and thus the deficit is clearly a poor indicator of jobs that have actually been lost because of trade. Instead, the deficit simply indicates that Americans are buying more goods and services than the economy is able to produce at home, and the jobs being "lost" are not actual jobs, but jobs that would hypothetically be filled if the US spending rate were maintained and the domestic economy were able to produce more than it currently can.

11. Peter Navarro, "Why the White House Worries About Trade Deficits," *Wall Street Journal*, March 6, 2017.

Figure 2 Relationship between US employment and imports (1990–2016)

Source: Bureau of Economic Analysis.

Figure 3 Relationship between US GDP growth and trade balance as a share of GDP (1999–2017)



Source: Bureau of Economic Analysis.

MISCONCEPTION 4: TRADE PERFORMANCE IS THE MOST IMPORTANT REASON FOR THE LONG-RUN DECLINE IN US EMPLOYMENT IN MANUFACTURING

In the Trump narrative the US trade deficit in international trade in manufactured goods is responsible for the decline in manufacturing employment experienced in recent decades. In his inaugural address Trump spoke about the "ravages of other countries making our products, stealing our companies, and destroying our jobs."

Distinguishing the causes of import growth is however crucial for understanding the role played by international trade in the decline in manufacturing employment. While undoubtedly trade has played a role in the painful loss of jobs that has devastated US communities in the Midwest and elsewhere, the evidence suggests it has been a much less important factor than Trump suggests.

A careful study by Acemoglu et al. (2016) separates determinants of import growth and, rather than claiming that all imports cause job loss, carefully estimates only the effects of increases in Chinese competitiveness on US manufacturing employment. The authors find that from 1999 to 2011, when US manufacturing employment declined by 5.5 million, the loss of manufacturing jobs attributable to imports from China amounted to about 1 million. This is a substantial impact, but their analysis also implies other factors have accounted for more than 80 percent of the job loss in manufacturing over the past decade.[12]

It is noteworthy that the share of US employment in manufacturing began declining in the 1960s, long before the economy was heavily exposed to trade, and that the declines in the share of manufacturing employment in industrial countries with large surpluses in manufacturing trade, such as Germany, Italy, and Japan, has been similar to the declines in the share of manufacturing employment in the United States and other countries with trade deficits.

This evidence suggests that most of the declining share of employment in US manufacturing reflects factors other than the trade deficit. The share of manufacturing employment in all major industrial countries, including those with large trade surpluses, has declined since the early 1970s. The primary reason for these declining shares has been rapid productivity growth coupled with demand that is relatively unresponsive to lower goods prices and higher incomes (Lawrence 2017). What has happened to employment in manufacturing is therefore quite similar to what happened earlier to employment in agriculture. Despite its trade surplus in agriculture, the United States employs far fewer farmers because demand for food has not kept pace with increased farm productivity.

MISCONCEPTION 5: BILATERAL TRADE BETWEEN COUNTRIES SHOULD BE BALANCED

One of the benefits of trade is it provides countries with the ability to buy from some partners and sell to others. The preference for balancing bilateral trade, as reflected in the Trump administration's perspective that having a trade deficit with Mexico is unfair, is as misplaced as would be a preference for an economy based on barter rather than on money. A monetary economy is superior to a barter economy because it does not require that both parties have exactly what the other wants, or "a double coincidence of wants." It allows individuals to specialize and earn money by running surpluses with their employers and then spending money on goods and services that meet their needs by running deficits with everyone else. By analogy, in not balancing trade bilaterally, a country reaps gains from trade by exporting to those nations that need the products in which it specializes, and then importing from other nations that produce the products best suited to its needs. If a bilateral free trade agreement allows a country to meet more of its needs by importing at lower costs from a particular partner, it will benefit, even if the value of these increased imports exceeds the value of the exports that it sells to that partner. In particular, US trade agreements with Mexico or Korea could be a success if they allow US consumers to buy goods at lower prices and/or higher quality than from other trading partners, even if the value of these goods is greater than US exports to these countries.

Judging the success or failure of a trade negotiation (e.g., NAFTA renegotiation) in terms of whether it will create a net trade surplus or a net trade deficit for the United States is simply wrongheaded. First of all, a trade agreement like NAFTA *cannot logically lead to a net trade surplus for all of the parties*. Some parties will find themselves with a resulting net trade deficit vis-à-vis other partners to the agreement. What if NAFTA renegotiation does not reduce or eliminate the US bilateral trade deficit with Mexico and/or Canada? Does this mean that they did not negotiate hard enough, or should have not participated in the trade pact? No, because the *objective of a trade pact is to allow all parties to use their resources more efficiently*, not to change the bilateral trade balances. Of course the United States should be forceful in trade negotiations to remove obstacles to the penetration of US goods and services, but this is because the United States would benefit if the economy operates as efficiently as possible, not because it will affect bilateral trade deficits.

12. In 2011, for example, US employment in manufacturing was 11.7 million. If the United States had replaced the manufacturing value added in its trade deficit with domestic value added, its manufacturing sector would have been 8.4 percent larger—translating to about 1.2 million jobs. This calculation relies on value-added data available from the OECD Trade in Value Added (TiVA) database (available at https://stats.oecd.org/index.aspx?queryid=75537, accessed March 6, 2018).

CONCLUSION: WHAT GOOD TRADE SHOULD FOCUS ON

The chain of causation posited by the Trump administration that runs from unfair trade and bad trade agreements, to large trade deficits, employment declines, and reductions in welfare and growth reflects flawed thinking. Over the long run, trade policies are not the most important cause of fluctuations in the trade balance; changes in the determinants of national saving and investment are. Moreover, the state of a nation's trade balance per se tells us very little about the health of its economy. Trying to achieve balanced trade (or surpluses) with individual trading partners will only generate distortions and constrain the diversity of goods for purchase while raising prices, with little or no benefit to national welfare.

Even though trade policies are unlikely to change the long-run trade balance, they are not unimportant. Americans will be better off if the United States can use trade negotiations to open foreign markets for its exports, not because more exports will increase the US trade surplus, but rather because US incomes will be higher if more US workers can be employed in the most efficient US firms that pay high wages, and if those firms can sell more exports at higher prices. Similarly, US living standards will be higher if the United States reduces its trade barriers at home because this will give consumers access to cheaper imports and make the economy more efficient. Ultimately, therefore, the goal of US trade policies should not be focused on trade balances but instead on eliminating trade barriers at home and abroad.

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