The Daily Dish

Policy Nostalgia

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One can imagine – well at least Eakinomics can imagine – a situation in which the government budget is balanced, private domestic saving is used to finance private domestic investment, and there is no trade deficit. Everything is nicely in balance. Suppose then, that the government spends more – say $100 billion – or taxes less by the same amount. There result would be a budget deficit of $100 billion and the need to issue $100 billion of Treasury debt.

The government is now competing with its private sector for the pool of domestic saving, driving up interest rates. This sets off a chain reaction. Overseas capital flows into the United States in search of the higher return. Domestic investment and the government borrowing will now be financed by some combination of domestic saving and the capital inflow. And the inflow of capital means the demand for dollars rises, leading to an appreciation of the dollar, which makes imports cheaper and exports less attractive.

The upshot will be a federal budget deficit, higher interest rates, perhaps some diminished investment due to the higher rates, a stronger dollar, and a trade deficit. Sound familiar? In the old days, this was referred to as "twin deficits" – the coincidence of a budget deficit and a trade deficit (or current account) deficit.

Is the solution to demagogue the actions of trading partners and build a massive tariff wall? Uh, no. The actions that mattered were right at home: budget deficits. And building a tariff wall will be absolutely ineffective in dealing with the trade deficit. As long as budget deficits are eating into the dollars needed to fund domestic investment, capital will flow into the country, and its mirror image will be the trade deficit.

No, the solution would be to get the budget under control and undo the source of the twin deficits: the federal budget. This would deal with the trade deficit and high interest rates at the same time.

The Trump Administration has placed the trade deficit at the center of policymaking but offered no good solutions to it. It is dealing with the fallout of a deficits and debt situation that is a real threat to the economy. It’s time to take on the budget deficit for its own sake and as a route to better terms of trade.