The Daily Dish

Reducing Trade Deficits – A Road Not Taken

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There are two frustrating aspects to the Trump Administration's trade policies. The first is the obsession with bilateral trade balances, which have essentially no real policy content and are largely driven by differences in comparative advantages, natural resources, and the like. I, for example, run a trade deficit with P.F. Changs because it is endowed with Asian food and my condo is not. It has stuff I want, and I have nothing it wants or needs (except, of course, my money, which it will then use to trade with someone else). I voluntarily run a deficit because it beats the living daylights out of cooking. Nobody is cheating in this trade relationship.

The second is the focus on the trade deficit (indeed, the goods trade deficit) to the exclusion of discussing international capital flows. The two are intimately linked, as any deficit in the trade accounts will be matched by an identical surplus in the capital account, and vice versa. Americans invest more in factories, equipment, structures, software, and the like than its households, firms, and governments collectively save.

It fills the financing gap through inflows of capital from abroad. As it turns out, because the United States is running trade deficits, our trading partners accumulate surpluses that are available to invest here. These two must match, so if national investment doesn't change, and national saving doesn't change, then the trade deficit will not change – no matter what universal, sectoral, reciprocal, or monomaniacal tariffs are imposed. Sure, the quantity of trade may be affected, but the value must match the capital account. Tariffs will simply produce exchange rate movements.

There is a flip side to this link that is important. If the United States were to save more, it would need less inflow of capital to finance the same investment. The capital account surplus would shrink and so would the trade deficit. Intuitively, with fewer overseas actors buying dollars to invest in the United States, there would be less upward pressure on the

dollar. This would reduce imports and improve exports.

The quickest way to raise national saving is to have smaller federal budget deficits. As shown in the table (below), the federal budget deficit has averaged 5.9 percent of gross domestic product (GDP) over the period since President Trump first took office (excluding the COVID-influenced year 2020). Over that same period, the trade deficit has averaged 3.1 percent of GDP. Indeed, the United States has run a current account deficit every year in the 21st century, to which the president pointed when declaring an international economic emergency.

Suppose that instead of budget deficits ratcheting ever northward, they had been held at 2.2 percent of GDP, the average deficit in the fiscally sane era from 1960–2000. It turns out that reducing the federal budget deficit by 1 percentage point of GDP does not raise national saving by 1 percentage point. Instead, the empirical record indicates that if the government is less profligate in its spending, the private sector feels the need to save less. On average for every dollar of reduced budget deficit, private saving declines by $0.43. Nevertheless, on balance national saving will rise.

If one replaces the history of federal deficits with the "hypothetical" budget deficits and – leaving everything else unchanged (which is not, by the way, how the world actually works) – recalculates the trade deficit, the result is the bottom line "hypothetical trade deficit."

The basic lesson is clear. If you want smaller trade deficits, stop being so fiscally irresponsible. (This includes the Biden era.) It is also a twofer because the federal debt threat would be diminished as well.

This calculation is the upper bound of what would be accomplished. But while the magnitudes would be smaller, the basic lesson is unchanged. There were, and are, ways to reduce trade deficits that do not involve tariffs, upsetting global trade relations, and undermining international relationships. They simply involve taking care of business on the budgetary front.

Why not give that a try?

									AVERAGE
	2017	2018	2019	2020	2021	2022	2023	2024	(excl. 2020)
Budget Deficit (% GDP)	3.4%	6.2%	5.6%	19.8%	6.3%	5.4%	8.1%	6.3%	5.9%

Trade Deficit (% GDP)	2.8%	2.9%	2.7%	2.9%	3.6%	3.7%	2.9%	3.1%	3.1%
Hypothetical Budget Deficit (%GDP)	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%
Hypothetical Trade Deficit (%GDP)	2.1%	0.6%	0.8%	-7.1%	1.3%	1.9%	-0.5%	0.%	1.0%