Why the trade deficit matters, and what Trump can do about it

By Eduardo Porter
October 17, 2017 – *The New York Times*

President Trump surely remembers when Japan was eating America's lunch.

Back then, in the late 1980s, he was mulling running for president for the first time and using Japan's trading surpluses as one of his talking points. On Sept. 2, 1987, he took out full-page ads in The New York Times, The Washington Post and The Boston Globe to excoriate Japan for building a "vibrant economy with unprecedented surpluses" at the expense of enormous deficits suffered by the United States.

Three decades later, some protagonists have changed, but the plot remains the same. Hobbled by a two-decade slump, Japan is out of the picture. Mr. Trump's main nemeses are now Mexico and China, and he remains fixated on getting even.

"The jobs and wealth have been stripped from our country year after year, decade after decade, trade deficit upon trade deficit," he said in March — as he ordered up a country-by-country review of the nation's trade imbalances.

The president's focus is misguided, of course. Bilateral trade balances are not a measure of comparative prowess. His proposals to reduce them by pulling the United States out of the North American Free Trade Agreement and slapping tariffs on Chinese goods would not create manufacturing jobs in the United States. Instead, they might generate jobs in another country with cheap labor, or lead to more automation.

And yet the president's political success, 30 years after his diatribes against Japan, underscores just how much the trade deficit matters. A symbol of America's malaise, it helped propel his insurgent candidacy to the presidency by harnessing beleaguered workers' anger at the status quo.

As C. Fred Bergsten, founder and director emeritus of the Peterson Institute for International Economics, told me, "Even if the deficit is financeable it is not sustainable in domestic political terms."

The trade deficit's political power raises a question that seems overdue: Why has an advanced nation like the United States allowed such large imbalances to persist for such a long time? Perhaps there is a case for policy makers in Washington to do something to narrow the gap.

The American current account deficit — the broadest measure of the balance of trade in goods and services — is an anomaly.

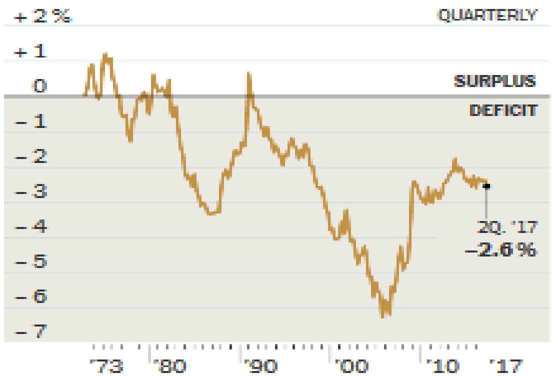
Economists' standard explanation of international trade says that rich countries like the United States will export capital, of which they have a lot, lending to poorer nations that have little capital but a lot of cheap labor. These poor countries, in turn, will invest the borrowed money in American-made machines for factories in which to employ their workers. So the lending will generate exports for the United States — building a trade surplus.

Most developed nations adhere to this pattern most of the time. The European Union now has a current account surplus. If it weren't for the United States, so would the G7 group of major industrialized countries. But since 1980, the United States has found itself mostly on the borrowing end of the deal. It has used the foreign capital to finance investment at home, racking up huge trade deficits along the way.

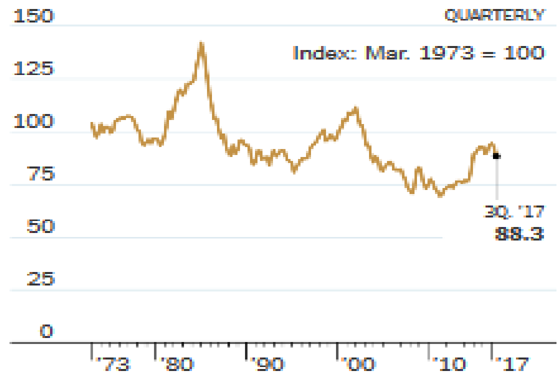
American Imbalance

The United States' large and persistent current account deficit — the broadest measure of its trade in goods and services — is an anomaly among rich countries. The main reason for the deficit, economists argue, is the strong dollar.

U.S. current account balance, as a share of Gross Domestic Product



Foreign exchange value of the U.S. dollar
Trade-weighted index of the value of the dollar against selected major currencies*



*Currencies include those of the eurozone, Canada, Japan, United Kingdom, Switzerland, Australia and Sweden.

By The New York Times | Sources: Organization for Economic Cooperation and Development (account balance); Federal Reserve Bank of St. Louis (dollar)

Some economists will argue that the trade deficit is ultimately irrelevant if there is sufficient money coming in from abroad to pay for it at a reasonable interest rate. So what if China owns a ton of Treasury bonds? Even fears that it might dump them to hurt the United States ignore that China has little incentive to do that. It would amass enormous losses, too.

But it is a mistake to ignore the wounds caused by persistent trade imbalances on American workers.

The trade deficit hasn't had a uniform effect across the economy. As it soared over the last half century, it was workers in industries that compete with imports — like manufacturing — who lost out. And employment shifted to industries that were not exposed to trade.

Even if trade with China did not reduce overall employment, convincing new research shows that the two-decades-old flow of imports from China caused lasting damage to communities where industries that competed with Chinese goods lost out and whatever new jobs emerged couldn't match the quality of those lost.

The money from China that financed the American trade deficit also financed the housing bubble, holding interest rates down in the run-up to the financial crisis of 2008. "China did not force our banks to make stupid subprime loans, but it enabled the macroeconomic conditions," Mr. Bergsten said.

The combination, Mr. Bergsten suggests, produced the protectionist backlash that delivered the presidency to Mr. Trump.

For all the angry rhetoric, there is little in Mr. Trump's campaign against foreign trade that might help turn around the nation's trade balance. Pulling out of trade deals won't do it. At best, this will reroute trade to other countries. His rallying cry against China's purposely weakening its currency — long a favorite on Capitol Hill — is pointless at a time when China is trying to push the value of the renminbi up, not down.

The United States has run large trade deficits when its trading partners were manipulating the currency and when they weren't. It ran large trade deficits when President Ronald Reagan ran large budget deficits. It ran them again when the Clinton administration turned the budget deficit into a surplus — a change that should have increased national savings, economists argued at the time.

Economists argue that the deficits will stop when Americans stop consuming and investing more than they earn, reducing the demand for money from overseas. But that is easier said than done.

The one straightforward recommendation to address the trade deficit would be for Mr. Trump to do something he surely won't: drop the rest of his promised economic agenda, starting with his multitrillion-dollar tax cut, which would reduce national savings and make the trade deficit balloon.

But slashing the trade deficit for good will be very tough. That would require weakening the American dollar, the reserve currency of the world. That would be no easy task.

The dollar is the main currency used in global trade, as well as international capital market transactions. People and governments the world over store their wealth in American stocks and bonds. What's more, the dollar is the go-to currency in the time of financial crises, even if the crises at hand are centered in the United States. Against these forces it is hard to keep the dollar down.

Still, there is a promising path that Mr. Trump could pursue. The United States tried it before, two years before he ran his ads bashing Japan. The budget deficit was bloated. The dollar was soaring. And at the Plaza Hotel in New York, Treasury Secretary James Baker convinced Japan and West Germany that it was in their best interest to help the dollar fall.

All Mr. Baker had to do was convince his counterparts that if they didn't play they might risk protectionist moves from Congress. And by 1989, the dollar had fallen 50 percent against the Japanese yen and more than 40 percent against the West German mark.

This kind of approach seems like a perfect fit for Mr. Trump, who tends to enjoy making threats. If he did so, the trade deficit might even close. In 1991, the United States even ran a current account surplus for two full quarters.