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Seeing Past the Trade Deficit Threat

By N. Gregory Mankiw

The economic policy of President-elect Donald J. Trump is still a work in progress. But if campaign rhetoric is a reliable guide, reorienting trade policy may become one of the main goals of the new administration.

Perhaps the best indication of Mr. Trump's thinking is a report released by the campaign in September. The report, "Scoring the Trump Economic Plan: Trade, Regulatory and Energy Policy Impacts," was written by Peter Navarro and Wilbur Ross. Mr. Navarro is an economics professor at the University of California, Irvine. Mr. Ross is an investor whom Mr. Trump has chosen to be secretary of commerce.

A major theme of the report is concern about the trade deficit. In recent years, American imports have exceeded exports by about $500 billion a year. Mr. Navarro and Mr. Ross argue that if better policies eliminated this "trade deficit drag," gross domestic product would be higher and more people would be employed.

That conclusion is correct, but only in a superficial sense. Gross domestic product is, by definition, the sum of consumption spending, investment spending, government purchases and the net exports of goods and services. If net exports rose from their current negative value to zero, and the other three components stayed the same, domestic production would increase and, consequently, so should employment.

But a fuller look at the macroeconomic effects of trade deficits suggests that things aren't so simple.

The most important lesson about trade deficits is that they have a flip side. When the United States buys goods and services from other nations, the money Americans send abroad generally comes back in one way or another. One possibility is that foreigners use it to buy things we produce, and we have balanced trade. The other possibility, which is relevant when we have trade deficits, is that foreigners spend on capital assets in the United States, such as stocks, bonds and direct investments in plants, equipment and real estate.

In practice, these capital inflows from abroad have been large. Net foreign ownership of American capital assets has risen to about $8 trillion from $2.5 trillion at the end of 2010. American companies moving production overseas get a lot of attention, but this data shows that capital has, over all, moved in the opposite direction.

It is easy to understand why foreigners are eager to buy American assets. Despite the meager recovery from the financial crisis and recession of 2008-9, the United States remains one of the more vibrant economies of the developed world. And if you want a safe place to park your wealth, United States Treasuries are your best bet.

The trade deficit is inextricably linked to this capital inflow. When foreigners decide to move their assets into the United States, they have to convert their local currencies into American dollars. As they supply foreign currency and demand dollars in the markets for currency exchange, they cause the dollar to appreciate. A stronger dollar makes American exports more expensive and imports cheaper, which in turn pushes the trade balance toward deficit.

From this perspective, many of the policies proposed by Mr. Trump will increase the trade deficit rather than reduce it. He has proposed scaling back both burdensome business regulations and taxes on corporate and other business income. His tax cuts and infrastructure spending will most likely increase the government’s budget deficit, which tends to increase interest rates. These changes should attract even more international capital into the United States, leading to an even stronger dollar and larger trade deficits.

We have already started to see some of these forces at work. In the 10 days after Mr. Trump’s victory, the interest rate on 10-year Treasury bondsincreased by 46 basis points (0.46 of a percentage point). The dollar appreciated by about 4 percent against a broad basket of currencies to its highest level since 2002.

But what about those tariffs that Mr. Trump sometimes threatens to impose on foreign countries? They would certainly curtail the amount of international trade, but they are unlikely to have a large impact on the trade deficit.

When American consumers facing higher import prices from tariffs stop buying certain products from abroad, they will supply fewer dollars in foreign-exchange markets. The smaller supply of dollars will drive the value of the dollar further upward. This dollar appreciation offsets some of the effects of the tariff on imports, and it makes American exports less competitive in world markets.

But it doesn't matter much, anyway, because in reality, trade deficits are not a threat to robust growth and full employment. The United States had a large trade deficit in 2009, when the unemployment rate reached 10 percent, but it had an even larger trade deficit in 2006, when the unemployment rate fell to 4.4 percent.

Rather than reflecting the failure of American economic policy, the trade deficit may be better viewed as a sign of success. The relative vibrancy and safety of the American economy is why so many investors around the world want to move their assets here. (And similarly, it is why so many workers want to immigrate here.)

Mr. Trump says he wants to restore more rapid economic growth. That is a sensible goal. But focusing on the trade deficit is not the best way to achieve it.