Center for American Progress

Trump: Making the Trade Deficit Great Again

By Brendan V. Duke April 2017

President Donald Trump campaigned as a champion of American workers, but his administration is increasingly looking like that of a typical trickle-down conservative.

One area some believe could prove an exception is trade policy, where President Trump has promised to bring back good manufacturing jobs and reduce the U.S. trade deficit. While President Trump's discussion of trade policy is frequently filled with his usual falsehoods and distortions, there is truth to the fact that large, persistent trade deficits have contributed to stagnant wages and—when combined with low interest rates—falling employment rates for American workers.

But what President Trump has not said is that his economic agenda would actually cause the value of the dollar to soar. A more valuable dollar relative to other countries' currencies would cause the trade deficit to increase since U.S. exports would become more expensive and imports from other countries would become cheaper. President Trump has criticized our trading partners for increasing the dollar's value by manipulating their currencies but he may end up doing currency manipulators' work for them.

More specifically, President Trump's plan to enact massive, deficit-financed tax cuts and deregulate the financial industry would cause the U.S. dollar to rise, as would the very real possibility of his appointment of hawkish members to the Federal Reserve. The tax cuts alone could cause the trade deficit to grow $360 billion per year. Currency markets have expected the dollar to rise with the passage of President Trump's economic agenda, as the dollar rose three percent the week after his election, and we can expect it to rise higher if he successfully enacts his agenda.[1]

An overvalued dollar has been an enormous challenge for American workers over the past 15 years. Rather than fixing the problem, unfortunately, President Trump's plans would make it worse.

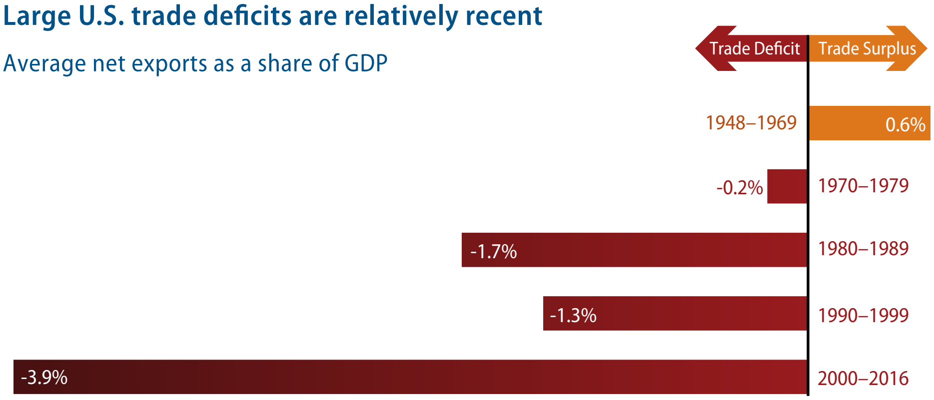
The effect of unbalanced trade on U.S. workers

The United States ran a $500 billion trade deficit in 2016, which means that it imported $500 billion more in goods and services than it exported.[2] It is important to note that large, persistent U.S. trade deficits are relatively recent. The United States consistently ran a trade surplus between the end of World War II and 1970.[3] During the 1970s and 1980s, the trade balance fluctuated between surplus and deficit. The deficit began to grow significantly in the mid-1990s and exploded during the 2000s.

FIGURE 1

Large U.S. trade deficits are relatively recent

Average net exports as a share of GDP



Source: Bureau of Economic Analysis, "Table 1.1.5. Gross Domestic Product," available at https://www.bea.gov/iTable/iTable.cfm?ReqID=9 (last accessed March 2017).

The trade deficit puts downward pressure on domestic wages and employment in tradeable sectors such as manufacturing. Yet, running a trade deficit also means importing capital to finance investment as other countries invest the dollars they receive from selling exports to the United States in U.S. stocks and bonds. Under some circumstances, this can have a positive, offsetting impact for workers: The trade deficit then lowers interest rates, spurring investment that can create new jobs and raise wages by enhancing productivity. Indeed, the unemployment rate has often fallen during periods when the trade deficit has risen.[4]

But in this current period of low interest rates, those offsetting benefits disappear and the trade deficit does indeed cost jobs.[5] The problem is that importing more savings from abroad does not increase investment because low interest rates are a result of too much savings chasing too little demand for investment. Moreover, the large capital inflows associated with a large trade deficit can also fuel credit bubbles such as the housing bubble during the 2000s—a bubble whose pop resulted in sharp declines in wages, employment, and middle-class wealth.[6]

Economists seeking to understand the negative impacts of unbalanced trade on U.S. workers have typically focused on China, given the explosive growth of the U.S. trade deficit with it.[7] The Economic Policy Institute, or EPI, estimates that the growth of the U.S.-China trade deficit cost 3.4 million jobs between 2001 and 2015.[8] A separate EPI study found that trade with less-developed countries reduced the annual wages of a typical worker by about $1,800, one-third of that reduction coming from China alone.[9] And a group of economists led by Daron Acemoglu and David Autor estimates that import competition with China eliminated as many as 2.4 million jobs between 1999 and 2011.[10]

In prior decades, job losses from trade deficits would not necessarily reduce overall employment since the Fed could offset the accompanying reduction in demand by cutting interest rates. The end result would be a shift in employment from tradable sectors such as manufacturing to nontradable sectors such as retail, but the overall level of employment would remain unchanged. Yet this has not been the case since 2008, as the United States has been operating at or near zero percent interest rates that make monetary policy less effective. Moreover, the Fed has become increasingly concerned about the effect of persistently low interest rates on financial stability, which further limits its ability—or willingness—to counteract the trade deficit.

Further research by Autor and others details just how destructive this so-called China shock has been for certain communities. Indeed, they find that heavy exposure to Chinese import competition in some local labor markets caused declines in employment and wages as well as increases in social safety net spending.[11] Moreover, a recent paper by those same authors found that import competition in some communities caused sharp declines in marriage among young adults and increases in the share of children born to unmarried mothers or living in single-headed households. The reason is that men in trade-affected areas have seen their value in the marriage market decline as a result of their increased joblessness, higher drug use, and other social problems.[12]

The problem of an overvalued dollar

There are several reasons for the explosion of the U.S. trade deficit. There is solid evidence that China's accession to the World Trade Organization caused large reductions in U.S. manufacturing employment.[13] This is accompanied by a U.S. trade enforcement regime that puts too much discretion in an executive branch that frequently prioritizes diplomatic priorities over rigorous trade enforcement.[14] And this is to say nothing of the role of broader transformations, such as technology and financialization, that have encouraged companies to offshore production.[15]

Many economists have focused, however, on the exchange rate as the biggest driver of persistent trade deficits. The dollar's value is typically measured against a basket of other currencies, such as the British pound, the Japanese yen, and the Chinese yuan.

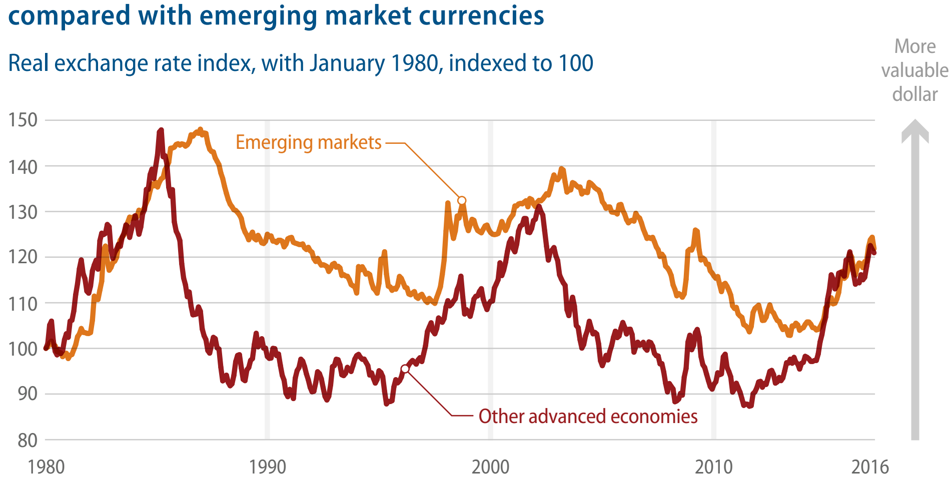
An increase in the dollar's value—that is, a dollar being able to purchase more British pounds, Japanese yen, and Chinese yuan—causes the U.S. trade deficit to rise for two reasons. First, U.S. consumers purchase more imports since their dollars can buy more foreign-produced goods. Second, exports fall as foreign consumers' pounds, yen, and yuan can purchase fewer U.S.-produced goods, and consumers therefore buy fewer of them.

The dollar has fluctuated in value against the currencies of other advanced economies, but the trend has been quite different when comparing its value with the currencies of emerging markets, such as China, Mexico, and South Korea. The dollar has consistently risen more quickly and fallen more slowly against those countries' currencies while remaining at an elevated level. Indeed, after the dollar rose in the mid-1980s, it has never once fallen back down to its 1980 value against these currencies. Unsurprisingly, it has been these emerging markets that have driven the increase in the U.S. trade deficit. The question is why that has been the case.

FIGURE 2

The dollar has consistently been overvalued compared with emerging market currencies

Real exchange rate index, with January 1980, indexed to 100



Source: Federal Reserve Bank of St. Louis, "Real Trade Weighted U.S. Dollar Index: Major Currencies," available at https://fred.stlouisfed-.org/series/TWEXMPA#0 (last accessed March 2017); Federal Reserve Bank of St. Louis, "Real Trade Weighted U.S. Dollar Index: Other Important Trading Partners," available at https://fred.stlouisfed.org/series/TWEXOPA (last accessed March 2017).

Some of the dollar's rise against emerging market currencies is a result of the 1997 Asian financial crisis, when countries such as South Korea were unable to pay their dollar-denominated debt when their currencies' value fell. The lesson emerging markets learned was that they needed to stockpile dollars to prevent another such crisis. But this cannot be the whole story, as the amount of dollar reserves these countries have accumulated far exceed any reasonable amount they would need to protect themselves from a financial crisis.[16]

Another reason why the dollar has grown in value is that countries realized that purchasing dollars would cause their currency to depreciate, increasing exports and reducing unemployment. Research by Joseph Gagnon at the Peterson Institute for International Economics finds that each dollar a country's government spends on purchasing dollar assets results in a 60 cent to $1 increase in its current account balance.[17] Governments have regularly been spending $1 trillion per year on dollar asset purchases, resulting in a drastic increase in the U.S. trade deficit.[18] Gagnon and his Peterson Institute colleague C. Fred Bergsten have estimated that currency manipulation cost the United States as many as 5 million jobs in 2011.[19]

China has received the most attention for the effects of its currency intervention, and its approximately $3 trillion in foreign exchange reserves reflects the colossal magnitude of its previous interventions.[20] Importantly, China has stopped purchasing U.S. dollars to hold down the value of the yuan and has, in fact, been selling U.S. dollars in order to raise its value.[21]

Nevertheless, currency manipulation remains a problem for two reasons. First, China is not trying to reduce the value of its currency at this time because its value has been falling on its own.[22] China's previous currency manipulation caused the U.S. trade deficit to rise by establishing a ceiling on the value of the yuan; the real test of whether the ceiling still exists is when the yuan is heading toward the ceiling, not the floor as it is today.

Second, China has been the largest currency manipulator, but it is certainly not the only one. Previous currency manipulators have included Japan, South Korea, Taiwan, and others, and some may still be manipulating their currency.[23] Many of these countries are not engaging in large-scale U.S. dollar purchases today since the dollar is already rising against their currencies, but they may begin manipulating again before China does. Moreover, past periods of currency manipulation and their impact on exchange rates can have persistent effects on investment and employment since firms make these decisions over long time horizons.[24] That means that the list of countries currently benefitting from past currency manipulation may be quite long.

Finally, the negative effects of an overvalued dollar and the accompanying trade deficits appear regardless of whether they are the result of direct currency manipulation or other factors that drive up its value. An increase in the dollar's value resulting from investors flocking to the safety of U.S. Treasuries as a result of an overseas financial crisis has the same effect as currency manipulation: an increase in the value of the U.S. dollar and a higher trade deficit. Unbalanced trade is the problem for U.S. workers, irrespective of its cause.

Trump and currency

President Trump's campaign, transition, and administration have made clear that reducing the U.S. trade deficit—especially with China—is a top economic policy priority. This is a laudable goal, as the U.S. trade deficit has been partially responsible for the low levels of demand that have resulted in stagnant wages and falling employment rates in this low-interest-rate environment. Most of Trump's trade rhetoric has focused on what he calls "bad trade deals," but he has also mentioned currency manipulation multiple times.[25]

President Trump's main remedy for addressing the currency issue during the campaign was that he would instruct his treasury secretary to brand China a currency manipulator on his first day in office. That still has yet to occur. A more natural opening for charging China with currency manipulation would be the release of the U.S. Department of the Treasury's report on currency manipulation in April. The problem is that China is not reducing its currency value through manipulation right now. Additionally, labeling a country a currency manipulator is simply that—a label. The president is only required to spend the next year negotiating with the country that has been named a manipulator, and the tools that the label would avail him are relatively toothless.[26]

The Trump administration has hinted that it will explore allowing the use of anti-dumping and subsidies disciplines that can result in the imposition of countervailing duties against products from countries that manipulate their currency.[27] This approach has a great deal of merit, but its effect is limited by three factors: Cases must be brought product by product; damage to domestic producers of each product must have occurred to prove each case; and cases can be expensive.

And even the most aggressive tactics for fighting currency manipulation will not improve the trade balance, since President Trump's economic agenda would drive the value of the dollar up, making U.S. exports less competitive. The likely combination of tax cuts and financial deregulation will cause the dollar to appreciate, as would the very real possibility of hawkish monetary policy.

In other words, Trump's agenda will cause the dollar to go up in value even if no countries manipulate their currencies again to bring their values down. The best evidence for this comes from the sharp appreciation of the dollar immediately after Trump's election. It immediately rose 1 percent the day after his surprise victory and an additional 2 percent the week after.[28]

Large tax cuts

One reason the dollar is likely to rise under President Trump is tax policy. Much debate has focused on how much the U.S. House of Representatives Republicans' border adjustment tax would increase the value of the dollar, but this has obscured the most important part of both President Trump's and House Republicans' tax plans:

They lose the country a lot of money. The nonpartisan Tax Policy Center, for example, estimates that the Trump plan would cost the Treasury $6 trillion and the House GOP plan $3 trillion over the next 10 years.[29] Passing either tax plan would almost certainly result in a higher fiscal deficit.

Many economists believe that higher fiscal deficits can lead to higher trade deficits when the economy is at or near full employment. The reason this can happen is the fiscal deficit would increase demand, which would cause the Fed to raise interest rates. The higher interest rates would cause money to flow in from abroad as investors seek to take advantage of the higher returns offered in the United States. The capital inflow would cause the dollar—and the trade deficit—to rise as investors purchase more dollar-denominated assets.

Economists at the International Monetary Fund have found a strong correlation supporting this hypothesis, suggesting that the trade deficit rises 60 cents for every dollar the budget deficit rises.[30] The $6 trillion Trump tax plan could, therefore, cause the trade deficit to rise about $360 billion per year, and the $3 trillion House GOP plan could increase the trade deficit about $180 billion per year.[31] There is precedent for this: During the 1980s, President Ronald Reagan caused the budget deficit to explode as he cut taxes and increased defense spending. This resulted in a soaring dollar and a rapid decline in manufacturing.[32]

Hawkish monetary policy

Another way President Trump may cause the dollar to rise is generally hawkish monetary policy. It is difficult to ascertain Trump's views on monetary policy, as he has sometimes said he has supported low interest rates and has other times criticized the Fed for low interest rates.[33] Nevertheless, the election of Trump rather than former U.S. Secretary of State Hillary Clinton increased the probability that the next president would appoint hawkish Federal Reserve Board members who would raise interest rates even higher than the Fed currently is.

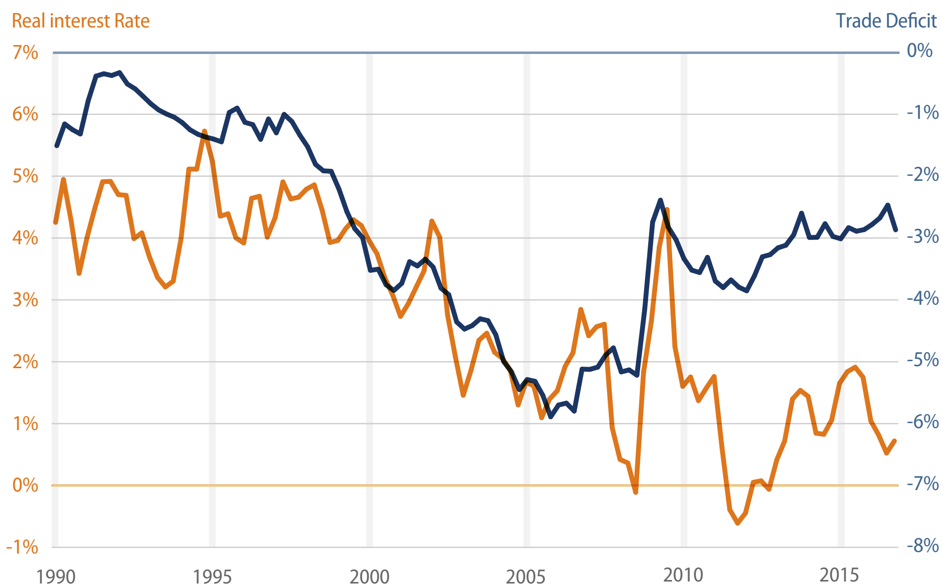
Leading Republicans in Congress have been quite aggressive in pressuring the Fed to raise interest rates despite low levels of inflation and wage growth. House Speaker Paul Ryan, for example, coauthored an op-ed with notable Fed hawk John Taylor of Stanford University in 2010 that criticized the Fed for its quantitative easing program and even suggested that it should only focus on low inflation, abandoning maximum employment as a goal.[34] Similarly, in February 2017, Rep. Jeb Hensarling (R-TX), chairman of the House Committee on Financial Services, told Federal Reserve Board Chair Janet Yellen that "there is zero evidence that zero interest rates and a bloated Fed balance sheet lead to a healthy economy."[35]

President Trump will have the opportunity to name at least three Federal Reserve Board members as well as his own Fed chair. If these appointees share typical Republican monetary policy views, it is likely that interest rates will rise more quickly, causing more capital to flow into the United States and the dollar to appreciate. This would again cause the U.S. trade deficit to rise and would reduce employment on top of the domestic channels by which higher interest rates reduce employment, such as curtailing investment.

FIGURE 3

Larger trade deficits go with higher interest rates

Net exports as a share of GDP and real interest rates, 1990–2016



Note: Real interest rate is the Treasury 10-year rate minus inflation, as measured by the Personal Consumption Expenditure Chain-type Price Index.

Source: Federal Reserve Bank of St. Louis, "10-Year Treasury Constant Maturity Rate, Percent, Quarterly, Not Seasonally Adjusted," available at https://fred.stlouisfed.org/series/DGS10 (last accessed March 2017); Federal Reserve Bank of St. Louis, "Personal Consumption Expenditures: Chain-type Price Index," available at https://fred.stlouisfed.org/series/PCECTPI#0 (last accessed March 2017); Bureau of Economic Analysis, "Table 1.1.5. Gross Domestic Product," available at https://www.bea.gov/iTable/iTable.cfm?ReqID=9 (last accessed March 2017).

Financial deregulation

The Trump administration has identified financial deregulation as another top priority and has already taken executive action to roll back the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Financial CHOICE Act, written by Hensarling, is the most likely legislative vehicle for efforts to undermine vital financial protections in Dodd-Frank, such as gutting the Consumer Financial Protection Bureau.[36]

Advocates for financial deregulation frequently argue that it will lead to more foreign investment in the United States, which will in turn create jobs and raise incomes. The investment resulting from financial deregulation, unfortunately, would likely turn out to be a debt-fueled bubble similar to the one that burst in 2007, which destroyed middle-class jobs, home ownership, and wealth.[37]

Financial deregulation would also cause the dollar to rise. Research by Oxford University economist Andrea Ferrero, for example, details how financial deregulation spurred the housing bubble of the 2000s, which in turn led to more borrowing from abroad and a higher trade deficit.[38] Similarly, a recent paper by Philip Turner, a former senior official at the Bank of International Settlements, details how financial regulation such as Dodd-Frank reduces interest rates and exchange rates.[39] Deregulation, therefore, would have the opposite effect: It would cause interest rates—and the value of the dollar—to rise.

Another likely effect is that financial service exports would increase, somewhat reducing the trade deficit. The financial sector, however, employs relatively few workers since they tend to be highly educated and are paid a high wage relative to the value they create.[40] Previous research has shown that one of the main effects of financial deregulation is that it draws into the financial sector highly educated workers who work in other sectors.[41]

In other words, these new exports will do relatively little to create jobs and raise wages for the workers who need them most. Indeed, it is difficult to imagine that high school-educated workers living in the middle of the country—the workers most affected by trade and deindustrialization—would find jobs with the investment banks and hedge funds that would benefit most from deregulation.

In fact, the financial services boom could actually end up hurting middle-class workers. The increase in financial service exports would cause the dollar to appreciate, reducing exports and employment in other sectors that employ middle-class workers. Indeed, this is a form of what economists call Dutch disease, which has typically been associated with natural resource booms in which exports rise and the currency appreciates but employment falls in all sectors that are not natural resource extraction. Economists have identified financialization as a problem in the United Kingdom and a contributor to its decline in manufacturing. [42]

Conclusion

President Trump campaigned on a pledge to fight for American workers, especially by cutting the U.S. trade deficit and bringing back manufacturing jobs. It remains to be seen whether he will take real steps to address the challenge of a frequently overvalued dollar. The problem is that his currency and trade policy may not matter as he advocates for a broader agenda that will almost certainly cause the dollar's value to rise. China and other trading partners will have no reason to depreciate their currency through manipulation when Trump's agenda will do it for them.

Brendan V. Duke is the Associate Director for Economic Policy at the Center for American Progress.

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