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Trade Deficit: Ask The Wrong Questions, Get The Wrong Answers

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President Trump signed an executive order on March 31 requesting an "Omnibus Report on Significant Trade Deficits." This report "shall identify those foreign trading partners with which the United States had a significant trade deficit in goods in 2016." The policies of those countries are to be examined, including among others: tariff and non-tariff barriers, dumping, government subsidization, intellectual property theft, and "other factors contributing to the deficit."

Thank heavens for that final clause, "other factors contributing to the deficit." Looking at other countries' policies may tell us something about bilateral trade flows, but it will tell us very little about the overall U.S. trade deficit. With the exception of "other factors," the executive order is asking the wrong questions, so the report almost certainly will provide the wrong answers.

The trade deficit is driven by U.S. government policies that influence domestic savings and investment, not by the policies of governments overseas. The United States simply doesn't save as much as it invests. This leaves America with a massive financial/capital account surplus – people in other nations send a lot of money to this country every year to build factories, buy stocks, and fund the federal budget deficit. By definition, the balance of payments must balance, so the United States runs a current account deficit equal to the financial/capital account surplus. The trade deficit is the largest component of the current account, so the trade deficit also is large – $502 billion in 2016.

If the United States really was serious about reducing its trade deficit, it would curtail its demand for borrowed money by eliminating the federal budget deficit. The Congressional Budget Office reports that the 2016 budget deficit rose to $587 billion – even larger than the trade deficit. For good measure, the U.S. government also would reform the tax code to stop the taxation of interest earned on deposits, as well as ending the deductibility of mortgage interest. That would shift the policy bias away from borrowing, and instead would favor saving.

Unfortunately, the executive order seems premised on the mistaken notion that fixing trade-distorting policies of other countries would reduce the U.S. trade deficit. True, there are an abundance of government policies – both overseas and in the United States – that distort the flow of goods and services. Seeking their reform is entirely appropriate. However, those distortions largely have the effect of rearranging trade flows among countries, not increasing the size of the U.S. trade deficit.

As a hypothetical example, If China was to end a policy that subsidized the production of T-shirts, it might lead to higher prices. That price signal could cause a reduction in U.S. T-shirt imports from China. However, U.S. demand for affordable T-shirts would remain unchanged, so importers likely would increase purchases from Bangladesh. Reform of a trade-distorting policy easily could shift the origin of T-shirts entering the United States from one country to another, but the effect on the overall U.S. trade balance would be nil.

Many trade flows have very little to do with policies and much to do with economics. Comparative advantage still works in the 21st century – countries simply are better at producing some things than others. Even most protectionists recognize that America is better off importing coffee from efficient producers such as Colombia rather than trying to grow it here. Imports raise living standards; we shouldn't be afraid of them.

So what will the executive order accomplish? By identifying troubling policies overseas, it might help to determine future negotiating priorities. More likely, though, its built-in emphasis on other countries will tend to misinform the public and the White House itself regarding the root causes of the trade deficit.

Perhaps there is yet a glimmer of hope. Knowledgeable economists are employed at Commerce and USTR, as well as other departments involved in preparing the report. They may face pressure to produce a study consistent with the biases expressed in the executive order. Will those professionals stand aside and allow the real causes of the trade deficit to be swept under the rug? They would do a great service to the United States and to the global trading economy by looking beyond the wrong questions, focusing on "other factors contributing to the deficit," and striving to provide the right answers.

Daniel Pearson joined the Cato Institute after serving for 10 years on the U.S. International Trade Commission, the federal agency that, among other responsibilities, oversees the U.S. trade remedy laws. Pearson was nominated to the USITC by President George W. Bush and began his term as a commissioner on October 8, 2003. He served as chairman for the two-year term beginning June 17, 2006 and as vice chairman for the two-year term beginning June 17, 2008. Prior to joining the USITC, Pearson served as assistant vice president of public affairs and as a policy analyst for Cargill from 1987 to 2003. He was agricultural legislative assistant to Sen. Rudy Boschwitz of Minnesota from 1981 to 1987.