A War Everyone Loses

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Gary Cohn, the former Goldman Sachs executive who until recently served in the White House as top economic adviser to President Donald Trump, offered an interesting admission last month. "I have always said a trade deficit doesn't matter," Cohn said at a June 14 event sponsored by the *Washington Post*.

Interesting, that is, because Cohn's former boss has spent his campaign and presidency arguing just the opposite: that trade deficits do matter, and that the United States's trade deficits with countries like China are a big problem that needs fixing. Trump offers his protectionist trade policies and "smarter" bilateral trade agreements as the antidote. It was Cohn's inability to convince Trump otherwise that prompted him to quit his job as director of the National Economic Council in April.

The president has been nothing if not consistent in his views of trade deficits: He doesn't like them. "The United States has suffered massive trade deficits with Japan for many, many years," Trump said in November 2017. At a rally in March, the president blasted the $500 billion trade deficit we have with China as "no good." Later that month, at the signing of a presidential memorandum targeting Chinese trade practices, he again bemoaned the existence of the trade deficit. "We have, right now, an $800 billion trade deficit with the world," Trump said. "So think of that. So let's say we have 500 to 375, but let's say we have 500 with China, but we have 800 total with the world. That would mean that China is more than half. So we're going to get it taken care of."

At a press conference in Quebec following the G7 summit in June, President Trump responded to threats from allied countries to retaliate against his new tariffs on steel and aluminum with tariffs on U.S. goods. "Well, if they retaliate, they're making a mistake."

Because, you see, we have a tremendous trade imbalance. So when we try and bring our piece up a little bit so that it's not so bad, and then they go up—right—the difference is they do so much more business with us than we do with them that we can't lose that. You understand. We can't lose it. And as an example, with one country we have $375 billion in trade deficits. We can't

lose. You could make the case that they lost years ago. But when you're down $375 billion, you can't lose. And we have to bring them up.

Trump's view of trade deficits is not merely 180 degrees away from that of Cohn. Many economists and trade experts observe that the president appears to be ignorant of the factors that actually drive trade imbalances—and as a result he's drawing the wrong conclusions about deficits and how to fix them.

Trump's misunderstanding of the trade balance isn't unusual or all that surprising. It's a complex issue replete with counterintuitive terminology. Put simply, the balance of trade is defined as the difference between a country's exports and imports. If the United States exports more goods and services to a country than it imports from that country, it has a trade surplus; if it imports more than it exports, it has a trade deficit. The phrases "trade surplus" and "trade deficit" are descriptive of which direction the balance lies, but they say very little about the value of that balance.

The confusion arises from the use of the terms "deficit" and "surplus." When people talk about a *budget* deficit, they usually mean that an individual, business, or government is spending more money than it takes in—and that's a bad thing. A budget surplus, on the other hand, indicates there is more money in reserve than what we've spent, so let's use that extra cash to buy some champagne and celebrate! Doesn't the same principle apply to trade?

The short answer is: not necessarily. That's because trade, whether considered globally or bilaterally, isn't a zero-sum budget game. Despite the president's rhetoric, America doesn't always "lose" economic value when it imports more than it exports. In fact, when the United States has a trade deficit, it is often "paid for" by a surplus of foreign investment. That is, the cash flowing into the United States from exports, U.S. Treasury bonds, and other investment assets of foreigners is effectively equal to the amount we pay to foreign countries to import goods and services. That's the accounting relationship that really matters—not the one between exports and imports, but between so-called trade accounts and capital accounts.

Scott Lincicome, an adjunct scholar at the libertarian Cato Institute, says it "makes no sense to use the trade deficit as a trade policy scoreboard." There is near-universal consensus that trade balances have less to do with national trade policy than with macroeconomic factors such as differences between savings and investment, he says. Countries with high savings rates, such as Germany, tend to have trade surpluses. Countries like the United States, where consumers spend a lot, foreign investment is high, and the federal government runs a budget deficit, often have trade deficits.

"If we have low savings rates, high consumption, and a ton of attractiveness for foreign investment, we have a significant trade deficit," Lincicome says. "It's always frustrating when you hear the president, in one breath, bemoan the trade deficit, and in the next breath, celebrate all these foreign companies investing in the United States."

Some economists argue that trade deficits aren't always a good thing, but not for the reasons the president usually cites. Brad Setser of the Council on Foreign Relations says an overall trade

deficit can have the effect of driving up a country's external debt, for example. A debt increase could be exacerbated if our current low interest rates start creeping up, something he sees as a possibility.

"As interest rates normalize, one byproduct of that is it actually gets a little harder for the United States to run trade deficits without raising its external debt-to-GDP" ratio, Setser says. In other words, if we're importing more than we're exporting and interest rates go up, we'll have to borrow more money from overseas to finance the deficit.

Some voices from the left are also warning about trade deficits. Liberal economists Jared Bernstein and Dean Baker wrote in the *Atlantic* shortly before Trump's inauguration that although "it's not inherently a problem for a country to have a trade deficit," what matters are macroeconomic trends. In the post-2001 recession, they argue, the growing trade deficit "was subtracting from demand in the domestic economy" and exacerbating the weakness of the economy. The pair point to evidence that, even in boom times, the capital flow into the United States from countries with trade surpluses can contribute to financial-market bubbles.

And in a *Wall Street Journal* op-ed in May, Jason Furman, chairman of the Council of Economic Advisers under President Obama, expressed concern that borrowing from foreign governments like China to finance our trade imbalance could get more expensive and force drastic domestic spending cuts in the future.

Even for the economists who would like to see a more balanced trade regime, the Trump administration's proposed remedy of tariffs is a non-starter. "A trade war typically lowers the overall level of trade. It's not the most obvious way to change the balance of trade," says Setser. Instead, he says, more saving in the United States and looser fiscal policies in countries like Germany could do a lot more to shift the balance. Counteracting currency manipulation in Asian countries, he added, would be a better way to pursue trade balance.

"Trade balances overall are driven by giant, macroeconomic factors. If you don't change the giant, macroeconomic facts, good luck using tariffs," says Lincicome, who is skeptical of trade balance manipulation. He notes that while the United States is the world's biggest importer, it's also the second-largest exporter, just behind China.

But it's the bogeyman of China that most motivates Peter Navarro, President Trump's tariff-boosting Svengali. In a speech in March 2017, Navarro, just installed as head of the president's National Trade Council, insisted trade deficits, particularly those with China, "do indeed matter, and it is a critical economic goal and in the interest of national security to reduce these deficits in a way that expands overall trade." Navarro is nearly alone among economists and trade experts in his beliefs. But he's also alone in having President Trump's ear. Just ask Gary Cohn.