GEORGE W. BUSH
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Diagnosing the U.S. Trade Deficit:
Treat the Cause, Not the Symptom

"Comments Regarding Causes of Significant Trade Deficits for 2016"

Submitted: May 10, 2017

I. Trade deficits are not anti-growth.

To hear some people tell it, America's trade deficit is proof that foreigners are out-competing Americans and that the U.S. economy is failing. By this logic, exports are good because they create American jobs, and imports are bad because they supplant American jobs. It stands to reason that America is the chump of the global economy because its market is open to imports while it sits by and lets other countries prevent American goods from entering their countries.

Luckily for America, this way of looking at the trade balance and trade policy is almost entirely wrong. With this submission, the George W. Bush Institute argues that trade deficits are not inherently detrimental to, or subtractive from, the economic growth of a national economy. Furthermore, any effort to reduce the trade deficit should focus on reducing the U.S. federal budget deficit rather than imposing tariffs or other protectionist barriers to trade.

II. Trade is about people and firms, not countries.

People and firms buy things they need or want based on price, quality and their perceptions of value. If an American goes car shopping and chooses a Kia instead of a Ford because she believes that her money is better spent that way, this is not necessarily a net loss for the U.S. economy. If Ford buys a wiring assembly in Mexico that enables it to sell its car at a price that edges the Kia model out and gets that sale, isn't that a good thing for America? Ford, an American company with American investors and American workers, gets the sale and the market share and is able to keep making cars. Further, the consumer gets better value for her money, thanks to free trade and consumer choice.

But still: doesn't a trade deficit mean that money is flowing out of the U.S economy, making the U.S. poorer and enriching its trading partners? Isn't it like a household budget, where sooner or later you run out of money?

This is a tempting logic, but it is misleading. To understand why, we have to have a basic understanding of how national economies interact with one another.

III. Dollars that flow out flow back in.

A country's economic relationships with other countries are captured in the balance of payments, which summarizes all purchases and sales of goods, services, real estate and financial instruments like stocks, bonds and T-bills; as well as corporate investments in plant and equipment. As with trade, it's important to keep in mind that these transactions represent people going about their business: studying, training, making a living, saving, investing, buying things, taking vacations, remodeling their kitchens. However, it is not exactly like a checking account or a company profit and loss statement, which shows money coming in and going out and has a bottom line number that is either positive or negative.

A country's balance of payments is more like a corporate balance sheet, where assets and liabilities are by definition equal and add to zero. However, in the case of the balance of payments, we don't talk about assets and liabilities but rather about short-term transactions – the "current account," or transactions that will be completed within the year – and long-term transactions – the "capital account," or transactions involving investments that unfold over more than a year. Every transaction on one side has a counterpart somewhere on the other side, so the current account and the capital account are equal at the end of the year.

When it comes to trade, this means that the dollars Americans sent out of the country to purchase imports eventually return to the United States in one way or another. If foreigners use them to purchase equal amounts of American exports of goods and services, then the current account, which includes trade in goods and services as well as short-term financial flows like interest payments, is brought into balance.

If the current account is a negative number, which is the case when the U.S. runs a trade deficit with the world, then the capital account must be a positive number. That is to say, a current account deficit is the flip side of a capital account surplus, meaning dollars that flow out to buy goods and services turn right around and flow back in as foreigners buy capital assets in the U.S., such as stocks, bonds, plants, equipment, and real estate.

It's easy to see why this occurs: if Johann Schmidt in Germany sells a widget to John Smith in the U.S., what does Johann do with the dollars he receives in payment? Short of stuffing them in his mattress, he really only has two choices: he can use them to buy an American thingamajig or to invest in a company in the U.S. that makes gadgets. Either way, he is contributing to the employment of American workers and the expansion of the U.S. economy.

From this perspective, it is clear that a trade deficit is not an indicator of national economic failure. On the contrary, it is more like an indicator of success: it means the U.S. has a thriving economy that is an attractive place to do business and produces abundant wealth. It's no coincidence that many European social democracies with notoriously high unemployment and slow growth tend to have trade surpluses. Because their sluggish economies don't attract investment, their capital accounts are chronically in deficit, and their current (trade) accounts are in surplus.

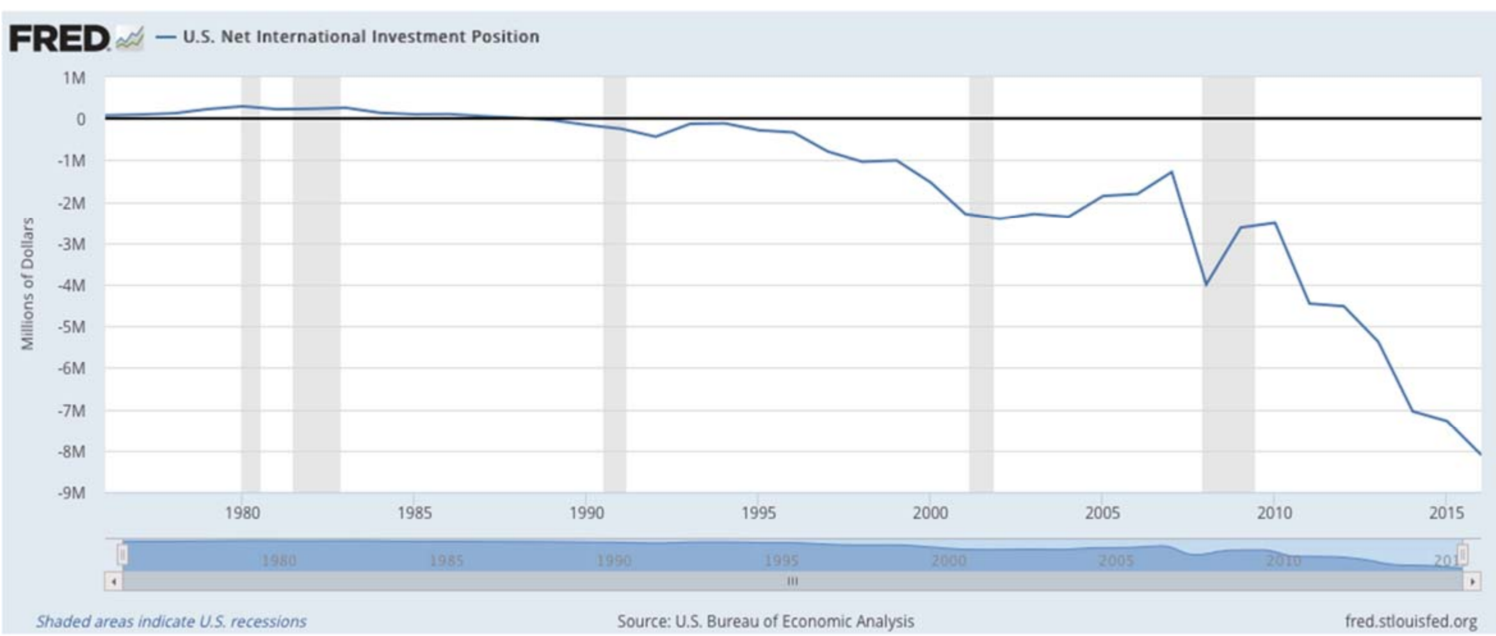
The two graphs below demonstrate the aforementioned symbiosis between dollars that flow out of the U.S. economy to purchase imports and dollars that return to the U.S. economy through capital investment. Graph 1 shows the current account balance for the U.S. over the past 50 years. Since 1990, the U.S. has maintained a sizable current account deficit, reaching as large as $800 billion in 2006. Graph 2 captures the reverse effect of such deficits, showing the rising accumulation of net international investment that has flowed into the U.S. over the past four decades. Just since 2010, net foreign ownership of

U.S. capital assets has risen from $2.5 trillion to about $8 trillion. Foreigners are so eager to buy U.S. assets because the U.S. remains one of the most vibrant economies in the developed world, despite its sluggish recovery from the 2008-2009 financial crisis and recession.[1]

[1] N. Gregory Mankiw, "Want to Rev Up the Economy? Don't Worry About the Trade Deficit," The New York Times, December 02, 2016, accessed May 02, 2017, https://www.nytimes.com/2016/12/02/upshot/want-to-rev-up-the-economy-dont-worry-about-the-trade-deficit.html.

Graph 1: Total Current Account Balance for the United States

Graph 2: U.S. Net International Investment Position



IV. Trade deficits do not subtract from GDP.

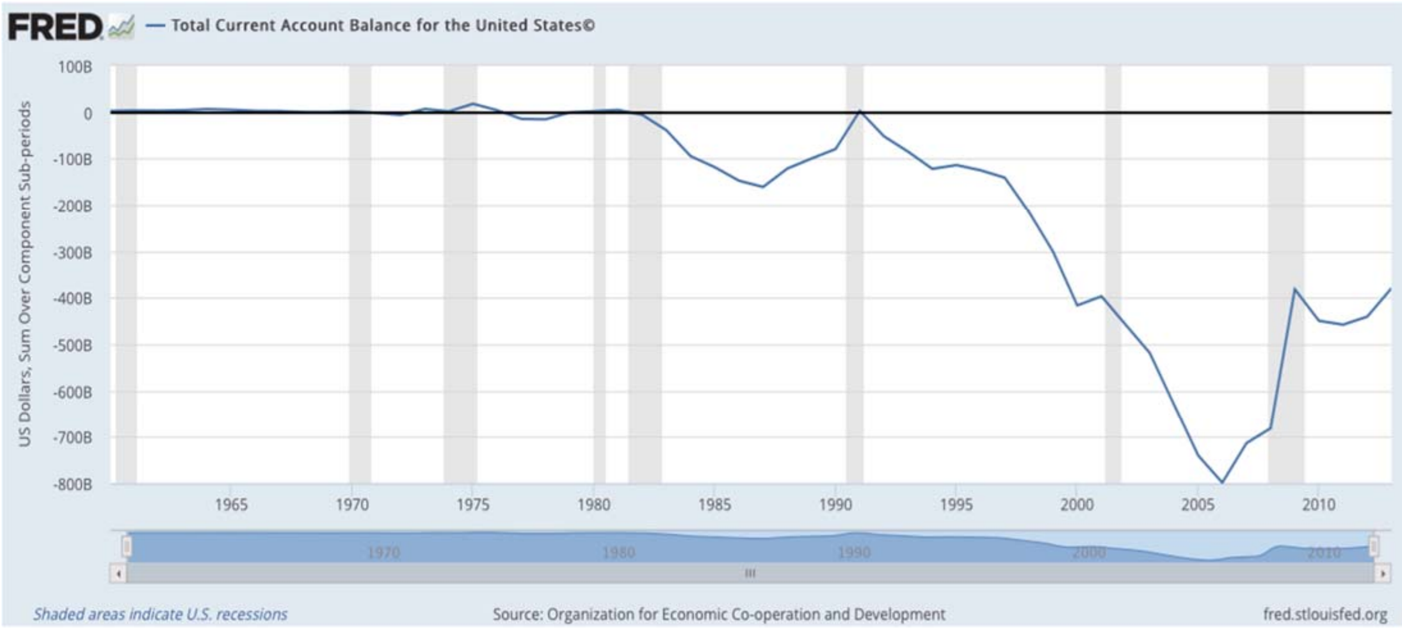
When looking at the GDP equation, Y = C+I+G+(X-M), simple addition suggests that a trade deficit drags down U.S. GDP growth. Per the equation, GDP equals consumption plus investment plus government spending plus the trade balance, measured as exports minus imports. It is tempting to look at this equation and jump to the conclusion that exports add to GDP and imports subtract from GDP. But don't forget: imports represent goods and services that are either consumed or used in the course of investing in plants and equipment. Subtracting imports simply avoids double-counting of imports – it doesn't mean that imports reduce GDP.

What, exactly, happens to the dollars that are sent overseas when Americans purchase imports? The answer, as previously explained in this document, is that these dollars are invested by foreigners into the U.S. economy through purchases of assets such as real estate, stocks, bonds, factories, and equipment. All of these investments are ultimately reflected in the consumption, investment, or government-spending portion of the GDP equation. Therefore, reducing imports and reducing the trade deficit will not, in and of itself, increase U.S. GDP.

V. Trade deficits and recessions are not correlated.

In fact, data actually show that growth in U.S. trade deficits often correlates with growth in the U.S. economy, and vice versa. To prove this, once again consider Graph 1, the U.S. current account balance, which is reproduced below. Periods of U.S. recession are shaded in gray on the graph.

Graph 1: U.S. Current Account Balance



Graph 1 clearly shows that prolonged periods of consistent, growing trade deficits, such as the early 1980s, the 1990s, and the early 2000s, have been accompanied by growth in the U.S. economy, indicated by the absence of gray shading. Conversely, during years when the trade deficit shrank, such as 1982, 1991, and 2009, the U.S. experienced a recession, as indicated by the gray shading. In 2006, when the U.S. trade deficit reached a record level of almost $800 billion, the unemployment rate fell to as low as 4.4%. In 2009, a trade deficit only half as large - $400 billion – was accompanied by an unemployment rate that reached 10%.[2]

For even stronger evidence against the idea that trade deficits are harmful to the U.S. economy, one can look back to the Great Depression. The U.S. ran a trade surplus in every year of the 1930s, despite being in the midst of the deepest economic downturn in the nation's history. Economic observations from around the globe also disprove the idea of a correlation between trade deficits and economic downturns. For example, Australia has run a trade deficit for decades, and it has not had a recession for about 25 years. Conversely, Japan often runs a trade surplus, and its economy has stagnated for decades.

More than anything, this data proves that trade deficits are not necessarily a bad thing for an economy. In the U.S., a trade deficit can signal economic health: it means that American consumers and businesses are experiencing savings by buying cheaper foreign goods, and that the U.S. economy is attracting overseas investment, which drives

[2] "U.S. Unemployment Statistics," U.S. Bureau of Labor Statistics, accessed May 02, 2017, https://data.bls.gov/pdq/SurveyOutputServlet.

productivity and demand for domestic and imported goods.[3] As the U.S. economy grows, U.S. consumers have the ability to purchase more and more foreign goods, all while the U.S. economy is attracting growing levels of foreign investment. As long as the U.S. continues to be one of the most attractive places to invest in the world, the desire to purchase U.S. assets will drive up the value of the dollar and keep interest rates low, conditions that contribute to an increase in the trade deficit.[4]

VI. When people buy U.S. dollars, it is like getting a loan.

To say a trade deficit is not an indicator of failure does not mean that a trade deficit is not important. For one thing, the dollar occupies a unique position in the global economy. In general, a currency is only in demand when the goods, services and assets in the country that issues the currency are in demand. People only buy Mexican pesos if they want to buy a Mexican product, go on vacation in Mexico, or buy a company in Mexico. However, people buy dollars for an additional reason: it is the global standard for value and U.S. Treasury bills are the global standard for secure savings instruments.

As a result, dollars circulate outside the U.S. economy for reasons unrelated to demand for American goods and services. This demand for dollars can drive up the value of the dollar, making American goods and services more expensive for foreigners and making imports of foreign goods cheaper for Americans, which in turn can reduce employment in the U.S. This is harmful to American workers, of course, but the benefit to the United States of owning that global reserve currency is significant. Think about it: it costs the U.S. about 14.3 cents to print a $100 bill, but foreigners will happily give America $100 worth of stuff in exchange for it. That's a profit for the U.S.A. of more than $99.85 – it's why the U.S. has been able to finance sustained government budget deficits and maintain very low interest rates. The U.S. should think long and hard before it gives up such an advantageous position.

What is more, using tariffs to combat the trade deficit may actually decrease the competitiveness of U.S. producers. In a recent NY Times editorial, renowned American macroeconomist N. Gregory Mankiw explains that tariffs, while likely to curtail the volume of international trade, are unlikely to have a large impact on the trade deficit. Mankiw goes on to say, "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

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[3] "Trade Deficit Myths," The Wall Street Journal, June 08, 2015, accessed May 02, 2017, https://www.wsj.com/articles/trade-deficit-myths-1433804035.

[4] Stefan Papaioannou and Kei-Mu Yi, "The Effects of a Booming Economy on the U.S. Trade Deficit," *Federal Reserve Bank of New York Current Issues in Economics and Finance* 7, no. 2 (February 2001), accessed May 2, 2017, doi:10.3886/icpsr01213.v1.

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."[5]

VII. Currency manipulation is ultimately self-defeating.

Another factor related to trade deficits is currency manipulation by governments. Sometimes, governments will use their own currency to buy dollars, bidding the dollar's value up and depressing the value of their own currency, in order to reduce their imports and give their exports a boost. China has been accused of doing this in the past ten years, and Germany and Japan did so in the 1980s. A policy like this can have an impact on trade balances and employment for some time, but it is unsustainable because driving down the value of your currency eventually causes inflation, which in turn leads to financial instability, interest rate increases, recession – and rising unemployment. It's why Japan has suffered slow growth for the past twenty years, and why China's economy has slowed sharply in recent years.

The challenge is that a policy like this is also very difficult to distinguish from a monetary policy intended to stimulate the economy in the face of a recession. There is a great deal of debate about the need for the U.S. to introduce disciplines on currency manipulation in future trade deals; this is probably necessary and desirable, but the U.S. should take care to do it in a way that doesn't constrain its own ability to manage the money supply and interest rates in the future.

VIII. Trade with Canada and Mexico makes the U.S. more competitive.

Partially in response to recurring U.S. trade deficits with Canada and Mexico, there has been recent discussion concerning a potential U.S. withdrawal from or renegotiation of the North American Free Trade Agreement (NAFTA). Despite claims to the contrary, withdrawing the U.S. from NAFTA would be destructive to the growth of the American economy and the competitiveness of the U.S. manufacturing sector.

U.S. consumers and workers have, on net, reaped immense benefits since the beginning of NAFTA. In 2014, the U.S. traded over $1.3 trillion worth of goods and services with its two NAFTA partners, equal to 7.6 percent of U.S. GDP. This figure has increased by 166 percent in real terms — from a little over $500 billion — since 1990. Perhaps surprisingly, over the same time span annual U.S. goods exports (think manufacturing) to the rest of the world have nearly doubled, surging from around $500 billion in 1990 to

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[5] N. Gregory Mankiw, "Want to Rev Up the Economy? Don't Worry About the Trade Deficit," The New York Times, December 02, 2016, accessed May 02, 2017, https://www.nytimes.com/2016/12/02/upshot/want-to-rev-up-the-economy-dont-worry-about-the-trade-deficit.html.

nearly $1 trillion in 2015.[6]

Without the ability to utilize supply chains that extend into Canada and Mexico, U.S. exporters would face a severe disadvantage when trying to compete against competitors in Asia and Europe, which use similar supply chains to manage costs and capture regional advantages due to specialization. In fact, "American" cars may have ceased to exist without NAFTA.[7]

Critics of NAFTA like to blame the deal for the loss of U.S. manufacturing jobs over the past two decades. However, such criticism ignores the fact that automation and technology, not Canadians and Mexicans, are responsible for most of the job losses in the U.S. manufacturing sector.[8] Despite first impression, this is not a bad thing: the current volume of U.S. industrial production is 42 percent higher than at the beginning of the 1990s.[9] That growth is only slightly less than Mexico's during the same time span, and Mexico started from a much lower base.

Moreover, since 1990 hourly earnings in U.S. manufacturing have increased by 53 percent.[10] The U.S. manufacturing sector is still achieving record levels of productivity, as fewer workers use sophisticated machinery and a high level of skill to produce more. What is more, the U.S. Chamber of Commerce reports that 14 million U.S. jobs depend on trade with Canada and Mexico, jobs that could be threatened with the elimination of NAFTA.[11]

NAFTA also creates substantial benefits for all three countries that extend beyond the sphere of trade. NAFTA has driven a process of converging environmental standards, safety regulations, and rules of business ethics that has improved working and living conditions in all three countries. These common standards signal credibility to the rest of the world, which has allowed North America to attract growing levels of international

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[6] IMF Direction of Trade Statistics and OECD.Stat – Trade in Services by Partner Country

[7] James Mcbride and Mohammed Aly Sergie, "NAFTA's Economic Impact," Council on Foreign Relations, accessed May 02, 2017, http://www.cfr.org/trade/naftas-economic-impact/p15790.

[8] J. Bradford DeLong, "NAFTA and Other Trade Deals Have Not Gutted American Manufacturing - Period," Vox, January 24, 2017, accessed May 02, 2017, http://www.vox.com/the-big-idea/2017/1/24/14363148/trade-deals-nafta-wto-china-job-loss-trump.

[9] Board of Governors of the Federal Reserve System (US), "Industrial Production Index," Federal Reserve Economic Data, April 18, 2017, accessed May 02, 2017, https://fred.stlouisfed.org/series/INDPRO.

[10] "Index of Hourly Earnings Manufacturing," OECD, accessed May 02, 2017, http://stats.oecd.org/index.aspx?DatasetCode=MEI_ARCHIVE.

[11] "Chamber of Commerce to Trump: Don't Mess with Trade," CNNMoney, accessed May 02, 2017, http://money.cnn.com/2017/01/11/news/economy/trump-jobs-chamber-commerce/.

investment since the beginning of NAFTA. For example, between 1990 and 2014, Mexico's inward stock of foreign direct investment (FDI) from North America grew by over 500 percent, from $19 billion to $190 billion. During the same time, Mexico's inward stock of FDI from the rest of the world expanded by an even greater 915 percent, from $21 billion to $219 billion.[12]

Thanks to free trade, America has been able to share in the success from the growth of Mexico's consuming class. Trade between the two partners is hardly a one-way street – and in fact, the U.S. benefits immensely from its ability to sell goods to Mexico (and Canada) with nominal tariffs. In 1990, Mexico was the destination for only about 7 percent of total U.S. goods exports. By 2015, that percentage had risen to nearly 16 percent. Canada and Mexico are the top two destinations for U.S. exports, together accounting for more than a third of the total. On top of all that, an estimated full 40% of the content in U.S. imports from Mexico, and 25% of the content in U.S. imports from Canada, actually represents value produced in the U.S.[13] These numbers highlight the prevalence of production sharing and the interdependent, mutually beneficial nature of North American supply chains

Furthermore, over half of all U.S. imports are intermediate goods and raw materials that go into supporting U.S. production.[14] Without free trade, these intermediate goods would become significantly more expensive, threatening jobs in the U.S. that depend on the use of these goods. For example, economists Joseph Francois and Laura Baughman estimate that after America imposed tariffs on foreign steel in 2002, more American workers lost their jobs from higher steel prices than the total employed by the entire U.S. steel industry.[15] A quarter of the lost jobs were in metal manufacturing, machinery, and transportation equipment and parts.

Note: All monetary figures are in inflation-adjusted 2015 U.S. dollars.

IX. Trade deficits can encourage workers to get retrained.

The international trade and payments cycle described above is not instantaneous, and numerous factors are at work at any one time. Imports may well supplant some jobs, even as they create other jobs elsewhere. Foreign investment certainly creates and sustains American jobs, but not necessarily the same ones that were lost when foreign imports

[12] "OECD Statistics Database," OECD, accessed May 02, 2017, https://data.oecd.org/.
[13] Christopher Wilson, "Working Together: Economic Ties between the United States and Mexico," Wilson Center, December 13, 2011, accessed May 02, 2017, https://www.wilsoncenter.org/publication/working-together-economic-ties-between-the-united-states-and-mexico.
[14] Douglas A. Irwin, "Free Trade Under Fire: Second Edition," Princeton University, 2005, accessed May 02, 2017, http://press.princeton.edu/chapters/s7938.html.
[15] "Teeing Up Trump Tariffs," The Wall Street Journal, April 20, 2017, accessed May 02, 2017, https://www.wsj.com/articles/teeing-up-trump-tariffs-1492730494.

pushed American goods out of the market. In short, trade brings churn as jobs are cut here and created there. Communities are affected, and new jobs may come with different requirements and different wages.

In this fashion, a trade deficit redistributes a country's available factors of production, namely labor and capital, to their most efficient use. Through this redistribution mechanism, trade initiates the creative destruction that allows industry in a country to transition from low-wage manufacturing to higher-value added sectors of production. Moreover, it expands the choice of goods and services available to consumers, which in turn lowers prices and raises quality.

In a highly innovative and educated country like the U.S., policymakers would be unwise to impede this creative destruction by reverting to protectionism. Efforts to retreat from the global marketplace will only undercut the gains the U.S. has achieved from free trade, like more affordable consumer goods and the ability to capture competitive gains from specialization across the North American continent. **A trade deficit (or a trade surplus, for that matter) may well require a policy response, but the appropriate policy response would encourage infrastructure investment to spread itself around, and encourage workers to move and/or seek retraining to acquire the skills necessary to compete in a rapidly evolving global marketplace.**

X. Trade deficits highlight domestic problems that need addressing.

Most importantly of all, a trade deficit points to imbalances elsewhere in the economy. A capital account surplus, for example, suggests that the economy is producing profitable investment opportunities that exceed what the available pool of domestic savings can finance. At one level, this is a good thing: the surplus country benefits from greater economic growth and job creation than it would achieve without that foreign capital. But it is worth asking why domestic savings are insufficient.

In the case of the U.S., it is mainly because of government borrowing to finance budget deficits. Less government borrowing would leave more savings in the domestic pool, so the economy would require less foreign capital, which would reduce the capital account surplus, which would in turn reduce the trade deficit. The reason this is true is that government borrowing tends to increase interest rates, which attract international capital to the U.S., bidding up the dollar and leading to larger trade deficits.[16]

A trade deficit that is driven by a budget deficit, such as the U.S. trade deficit, is in fact a serious problem – but the solution lies not in trade policies designed to limit imports, but rather in a focused effort to bring government spending in line with

[16] N. Gregory Mankiw, "Want to Rev Up the Economy? Don't Worry About the Trade Deficit," The New York Times, December 02, 2016, accessed May 02, 2017, https://www.nytimes.com/2016/12/02/upshot/want-to-rev-up-the-economy-dont-worry-about-the-trade-deficit.html.

revenue. Strengthening the federal government's finances has myriad benefits, including freeing up private capital for market-led investment that leads to innovation, job creation, and higher wages. In addition, the U.S. would be better able to confront crises of all kinds, and reducing the long-term expenditure on debt interest would enable decreases in government expenditures even as it freed up resources for investments in education, training and infrastructure. If market-led investments could generate sizeable realized gains, the U.S. government would be in a position to collect more tax revenue without raising rates. With more revenue, the government would be able pay down its debts and reduce its borrowing from foreigners, which in turn would reduce the country's capital surplus and reduce the trade deficit.

XI. In conclusion, beware of the wrong cure.

We can think about a trade deficit like a fever. It is generally better not to medicate the fever, but rather to seek the underlying cause. You might reduce the discomfort of a viral fever with some aspirin while you wait for the virus to pass, but a bacterial infection requires antibiotics. Aspirin won't cure the bacterial infection, and antibiotics won't kill a virus.

Attacking the U.S. trade deficit by imposing protectionist barriers like tariffs would be akin to simply treating the fever without seeking the underlying cause. What is more, these disproven and antiquated methods of protectionism would be like taking aspirin while the infection grows stronger, raising the cost of consumer goods and services, closing markets off from U.S. exports, and stifling innovation and the free flow of goods, services, and capital.

Instead, the proper medication for the U.S. economy is a focused effort to eliminate the infection of federal budget deficits by bringing government spending in line with revenue, coupled with a focus on ensuring that retraining and adjustment programs effectively prepare workers to thrive in a globalized, technologically-advancing economy.

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