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Opinion – Are Trade Deficits Bad?

By Robert Singer and Maryann Townsend

In defense of tariffs already or soon to be imposed upon China as well as other principal trading partners, President Donald Trump clearly expresses his long held position regarding trade policy:

"Because of Tariffs we will be able to start paying down large amounts of the $21 Trillion in debt…"

"Tariffs are working big time. Every country on earth wants to take wealth out of the U.S., always to our detriment. I say, as they come, Tax them."

The President wishes to reduce the U.S. trade deficit and suggests that such reduction would have beneficial effects on the economy. However, elimination of trade deficits is neither possible nor desirable. U.S. trade deficits are the product of two interrelated economic factors. The first factor relates to the principal driver of economic growth in the U.S.: consumption, which, accounts for 70% of U.S. GDP. In the context of international trade, as a nation, our spending preferences lead us to import more than we export. Since our trading partners run surpluses with us, they channel the funds back into the U.S. in the form of foreign direct investment and purchases of U.S. treasury securities. Since most of our trading partners find the U.S. to be a desirable venue for channeling excess funds, a surfeit of funds has always been available to finance our consumption and investment needs.

Suppose that the administration were able, through tariffs, to increase U.S. exports and decrease U.S. imports by enough to reduce the deficit to zero. It is highly unlikely that any increase in U.S. production would be able to meet domestic demand. We would find ourselves in the position of either having to reduce our consumption, increase our savings or perform some combination of both. As a nation, we have been unwilling to do either. The result of such a policy would be a reduction in economic growth, an increase in unemployment, and a significant decline in the value of the dollar. Clearly, such a chain of events could lead to a financial crisis and depression that would dwarf the 2007-08 financial crisis and the ensuing recession.

A second factor, which makes elimination of a trade deficit problematic as well as undesirable, relates to the dollar's role as the primary reserve currency. The U.S. dollar accounts for almost 2/3 of foreign reserve currencies held by international banks. Its strength over the euro, pound, and other reserve currencies allows the U.S. to maintain its economic dominance and arguably contributes to its role as the preeminent military power. Although the dollar has lost some of its luster from the post-war years as economies of allies and foes alike recovered dramatically from the ravages of war, its dominance continues unabated.

As mentioned, global investors and governments, through their central banks, seek dollar denominated investments to channel their savings, given their confidence in U.S. institutions, the depth and breadth of its capital markets, and rule of law. In times of financial stress, investors domestic and foreign invest in U.S. treasury securities. Given the dollar's dominance as the preferred global currency, trade deficits are indicative of the relative strength of the U.S. economy not weakness. Even if it were possible to reduce the trade deficit, we would almost have to forfeit the dollar as the primary reserve currency. Replacement of the dollar (in a worst-case scenario) by the yuan as China rivals the U.S. economically as well as militarily would greatly diminish our position as the premier global power.

Thus, any effort of the administration to eliminate trade deficits will prove futile, and more importantly, even if such elimination were possible, such a policy would have a disastrous impact on not only the U.S. economy but the global economy as well.

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