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CAPITAL ACCOUNT

Deficits Are a Flawed Guide to Unfair Trade

Global saving, consumption and investment, not tariff barriers, govern imbalances

Workers load rolls of sheet metal in Laredo, Texas, on the border with Mexico. President Donald Trump seems determined to narrow Mexico's trade surplus with the U.S. by renegotiating the terms of the North American Free Trade Agreement and applying tariffs. *PHOTO: ERIC GAY/ASSOCIATED PRESS*

By **GREG IP**

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President Donald Trump seems to be spoiling for a fight with some of America's biggest trade partners. The problem is how he judges victory. "I'm trying to find a country where we actually have a surplus of trade as opposed to a deficit," Mr. Trump groused last month.

If bilateral deficits are the marker he's using to make America great, Mr. Trump has set his team up to fail. It's a deeply flawed gauge of trade behavior that could lead the U.S. to pick the wrong fights.

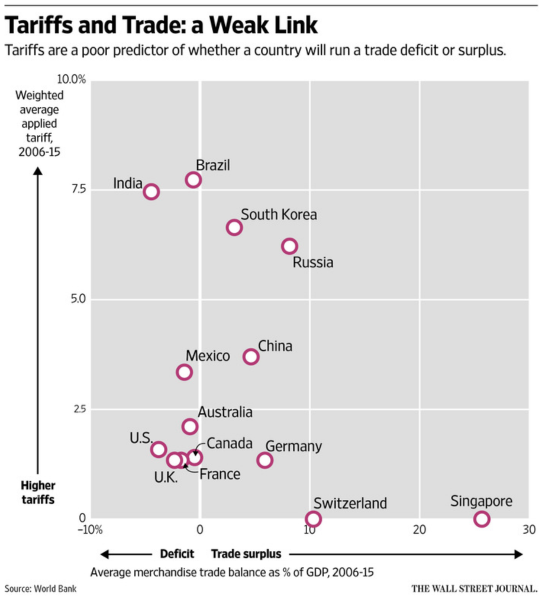
The U.S. has a trade deficit because it consumes more than it produces. Lacking sufficient savings, the U.S. sells assets such as stocks, bonds or other IOUs to foreigners to finance consumption and capital spending. A trade deficit always equals an inflow of foreign capital.

This deficit arithmetic isn't controversial; the dispute is over what causes it. Mr. Trump and Peter Navarro, director of his National Trade Council, blame unfair trade, arguing that other countries are cheating in the global trade arena. His critics say it's the appeal of the U.S. as a destination for investment.

Both arguments are an oversimplification. Trade deficits and capital inflows result from a combination of U.S. and foreign saving, consumption, and investment behavior, much of it benign but some of it not.

Mr. Trump's argument implies there should be some correlation between protectionist barriers and the trade balance. There isn't. Brazil and India are highly protectionist yet run persistent trade deficits because they save less than they invest. Conversely, Germany, and Switzerland have low tariffs yet run persistent trade surpluses because of their high saving relative to investment.

In an upcoming book, Joseph Gagnon and Fred Bergsten of the Peterson Institute for International Economics studied 125 countries and found that between 2003 and 2014, those with higher tariffs generally had bigger current account deficits or smaller surpluses than others. (The current account includes goods and services trade and income such as interest and dividends.) They couldn't find any statistically meaningful



link between the two. Some trade barriers don't appear as tariffs, such as local content requirements, but that doesn't appear to alter the overall relationship.

The reason is that exchange rates adjust. If the U.S. imposed an across-the-board tariff, it would tend to reduce demand for foreign currency, strengthening the dollar, making imports cheaper and exports more expensive and canceling out the effects of the tariff. If it imposed tariffs on just one country, that country's currency would fall. Its exports would be diverted to other countries, as would U.S. imports. The U.S. bilateral deficit might change; the overall deficit much less, if at all.

But this isn't to say that unfair trade practices don't matter. When another country subsidizes its exports and restricts imports, it benefits American consumers at the expense of domestic factory workers. U.S. imports of foreign goods or acquisitions of U.S. firms by foreign companies can cost the U.S. know-how, intellectual property and future high-wage jobs. A study by David Autor of the Massachusetts Institute of Technology and four others found that U.S. firms hit hardest by competition with Chinese imports reduce not just employment but also patents and research and development.

These are all legitimate concerns for policy makers; yet fixing them won't necessarily correct the overall deficit. In the 1980s voluntary export restraints on Japan helped create a thriving auto transplant sector, but the U.S. trade deficit still grew.

Persistent trade deficits usually reflect structural factors. The U.S. is virtually forced to run a trade deficit because safe-haven demand for its securities boosts both the dollar and capital inflows. Japan's high-saving workers fueled its trade surplus; as those workers have retired and spent their savings, the surplus has disappeared.

Robert Lighthizer, Mr. Trump's pick for U.S. trade representative, signaled in congressional testimony this week that he appreciates some of these nuances. "When I look at deficits, I try to ask myself, 'What does it tell me about the rules of trade?'" he told Congress. "Our objective is not just to get the trade deficit down. Our objective is to get more efficiency in the market, is to get rid of trade barriers everywhere."

The Trump team is correct in believing that sometimes trade imbalances reflect government tampering, though in the capital markets. Messrs. Gagnon and Bergsten found that countries who buy foreign currency to suppress the value of their own tend to have larger trade surpluses.

In the past Chinese currency intervention and tight controls on capital inflows kept the yuan artificially cheap and its trade surpluses inflated. Brad Setser of the Council on Foreign Relations says Taiwan and South Korea have held down their currencies via currency intervention and by encouraging domestic investors to buy foreign assets and discouraging foreign investors from buying domestic assets.

These actions are legitimate cause for complaint. Yet finding an effective deterrent has eluded previous presidents and it's not clear what Mr. Trump can do differently. Punishing China for manipulating its currency makes less sense now that China is trying to prop it up, rather than push it down as in the past.

Mr. Trump might use deficits to pick the wrong fights. Mexico runs a trade surplus with the U.S. Mr. Trump seems determined to fix it by renegotiating the terms of the North American Free Trade Agreement and slapping tariffs on companies that outsource production to Mexico.

But Mexico runs a trade deficit with the world as a whole. The U.S. would be attacking a country that on net is reducing the world's excess of saving, not contributing to it. If the economic and diplomatic damage weren't enough, that's one more reason for the president to be careful about how he picks his battles.

Write to Greg Ip at greg.ip@wsj.com

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