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Surprising Truths About Trade Deficits

By N. GREGORY MANKIW

President Trump has put trade policy at the center of his agenda. A case in point is the revised trade agreement with Mexico and Canada, announced on Monday. Yet it is hard to be sanguine about this accomplishment, in part because the changes are so modest but mostly because the president's overall approach to international trade is so confused.

Mr. Trump's confusion is understandable. Economists have spent centuries studying trade, debunking common myths and arriving at some surprising truths.

Let's review, both for the president and ourselves, some conclusions about trade that most economists accept but, upon first hearing, are not at all obvious.

Bilateral trade deficits don't matter.

When Mr. Trump discusses our trade relations with another nation, he often points to the bilateral trade balance — the difference between the value of our exports to that nation and the value of our imports from it. If imports exceed exports, we are running a bilateral trade deficit, which Mr. Trump interprets as a sign that we are the relationship's losers.

To understand what's wrong with that inference, consider some of the many bilateral trade deficits that I run. Whenever my family goes out to dinner, the restaurateur gets some money, and we get a meal. In economics parlance, the Mankiw family runs a trade deficit with that restaurant. But that doesn't make us losers. After all, we leave with full stomachs.

To be sure, I would be happy to have balanced trade. I would be delighted if every time my family went out to dinner, the restaurateur bought one of my books. But it would be harebrained for me to expect that or to boycott restaurants that had no interest in adding to their collection of economics textbooks.

I can run persistent trade deficits with restaurants because I run trade surpluses elsewhere. Take The New York Times, for instance. It pays me more for my columns than I pay it for my subscription. That's a bilateral trade surplus for me and a bilateral trade deficit for The Times. But nonetheless, we both gain from the relationship.

The overall trade deficit matters but not for what it says about trade.

If we add up all the bilateral trade balances with other countries, we get the nation's overall trade balance — the difference between the value of all United States exports and imports. For many years, the United States trade balance has been negative, meaning that total imports have exceeded total exports. Mr. Trump believes this trade deficit is a sign that other nations have been taking advantage of us.

To see the folly in that conclusion, consider again the Mankiw family. Our overall trade balance is the sum of all our bilateral trade balances with everyone else — restaurants, The Times, and so on. The end result equals the difference between our income and our spending.

If our overall trade balance is positive, we are spending less than we are earning, meaning we are saving. If our overall trade balance is negative, we are spending more than we are earning. In the language of economists, we are dissaving.

Whether a trade deficit represents a problem depends on whether our spending is prudent or profligate. When a family takes out a loan to buy a car, it runs a trade deficit, but that need not be a reason for concern, as long as it can afford the car in the long run.

On the other hand, if a family runs a trade deficit by persistently living beyond its means, that's a problem because debts eventually come due. But in this case, the trouble comes not from disreputable trading partners but from poor financial planning. If you eat at expensive restaurants too often, blame yourself, not the restaurateur.

Similar reasoning applies to countries. Nations run trade deficits when their spending on consumption and investment, both private and public, exceeds the value of goods and services they produce. If you really want to reduce a trade deficit, the way to do it is to bring down spending relative to production, not to demonize trading partners around the world.

Many of the president's policies will increase the trade deficit.

Mr. Trump thinks the trade deficit makes us losers in international trade, so he wants to shrink it. But many of his initiatives actually push in the opposite direction.

The tax cuts, for example, tend to increase private spending, by both households on consumption goods and businesses on investment goods. Reduced business regulation should also stimulate investment spending. Because the trade deficit represents an excess of spending over production, this increased spending results in a larger trade deficit.

Movements in the exchange rate help explain the link between spending and the trade deficit. As spending in the United States increases, the Federal Reserve will need to raise interest rates to keep inflation in check. Higher interest rates attract capital inflows from abroad, causing the dollar to appreciate. A stronger dollar makes our exports more expensive and our imports cheaper.

All this isn't to say that the president's policies are necessarily misguided. The tax bill should be interpreted on its own merits — whether it makes the tax system fairer and more efficient and whether it brings in enough revenue to finance the government. And each regulatory change should be evaluated based on its costs and benefits.

What these policies do to the trade deficit is, at most, a secondary concern. In many ways, the trade deficit is a fake problem. Our elected leaders should look elsewhere to gauge the success of their policies.

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