Reflections on the Trade Deficit and Fiscal Policy

N. Gregory Mankiw*

During my two years in Washington, one fact became very clear to me: Mercantilism is alive and well. The prevailing view in the nation's capital is precisely the view that Adam Smith campaigned against two centuries ago, and that the economics profession has long rejected. Under the mercantilist view, exports are good because they create jobs, and imports are bad because they take jobs away from Americans.

Economists understand that the mercantilist view has things almost exactly backwards: In truth, imports are good because they expand our consumption opportunities, and exports are the price we have to pay because foreigners want payment for the goods they sell us. But if you try to explain this fact to one of the Beltway mercantilists, the best response you can hope for is a polite, condescending smile, as he reflects on how naïve you are. More likely, he will act outraged and offended, and if you are a public official, he will call for your resignation. And I speak from a bit of experience.

Sadly, this mercantilist point of view has started to affect policy, or at least public discussion of it. It lies behind Senator Schumer's call for a 27.5 percent tariff on all imports from China until China revalues its exchange rate. And it lays behind some the rhetoric coming out of the Bush administration. On December 5, 2005, the White House put out a "Fact Sheet" on the President's "Agenda for Economic Growth" that lists the quotas on Chinese textiles as one of their accomplishments.

I am sure that the economics team inside the White House, including Al Hubbard, John Snow, and Ben Bernanke, knows that import quotas are bad policy from a strictly economic point of view. The quotas are a response to inexorable political pressure. At best, they are an attempt to foreclose even worse outcomes, such as Senator Schumer's tariffs.

But I also know that the communications team at the White House, who drafts such Fact Sheets, often has a different take on things. They are charged not with making policy but with selling it. If mercantilist arguments resonate with the public, then mercantilist arguments is what we will get. And some people on the communications team may actually have sympathy with this mercantilist point of view.

From the perspective of the Beltway mercantilists, the trade deficit is a huge national problem. They look at the trade deficit simply as lost jobs for Americans. In my view, the biggest risk about the trade deficit is that, combined with the widespread mercantilist worldview, it will strengthen the hand of the protectionists. I am far less

* Harvard University. These comments were prepared for the meeting of the American Economic Association, January 2006, for a session titled "Trade Deficits, Growth, and Stability of the U.S. Economy," organized by Dominick Salvatore.

worried about the trade deficit in and of itself than I am in the possibility that it will end up giving Senator Schumer and his colleagues the upper hand in the debate over trade policy.

Most economists, when thinking about the trade deficit, focus on the other side the coin—the capital account surplus that is needed to finance the trade deficit. There are at least three points of view on the inflow of capital that the United States has experienced in recent years.

One point of view suggests that the trade deficit is no big deal. If Japan were to start buying large quantities of steel, lumber, glass, and furniture from the United States, we would call that an export and our trade deficit would shrink. But if instead Japanese investors buy office buildings in New York made of American steel, lumber, glass, and furniture, that purchase is a capital account transaction. Because there no reason to prefer that Japanese buyers take delivery of their steel, lumber, glass, and furniture in Tokyo rather than New York, one can argue that we shouldn't be terribly concerned about the trade deficit.

As far as I can tell, this is close to the view that Ben Bernanke has expressed when he suggested that the U.S. trade deficit reflects a "global saving glut." With so much saving in the rest of the world, it is natural that foreigners would want to invest some of that saving in the United States rather than on their own shores. And there is no particular reason that we should object to their doing so.

A second point of view is that the trade deficit and the accompanying capital inflows are a problem because they are a financial crisis waiting to happen. Paul Krugman has pushed this perspective in his New York Times column. Almost exactly one year ago (January 6, 2004), Krugman wrote:

> "The traditional immunity of advanced countries like America to third-world-style financial crises isn't a birthright. Financial markets give us the benefit of the doubt only because they believe in our political maturity — in the willingness of our leaders to do what is necessary to rein in deficits, paying a political cost if necessary….If this kind of fecklessness goes on, investors will eventually conclude that America has turned into a third world country, and start to treat it like one. And the results for the U.S. economy won't be pretty."

Of course, the Krugman catastrophe scenario hasn't materialized, lending some credibility to the Bernanke "What-me-worry?" hypothesis. The nice thing about such crisis predictions, however, is that they are probabilistic, so Paul would surely just say we've been lucky—so far.

My own view of the trade deficit and capital inflows is somewhere between Bernanke's and Krugman's. I don't rule out the Krugman financial crisis scenario, although I would bet against it. In fact, I am betting against it in my personal portfolio, where I am happily holding U.S. equities and dollar-denominated bonds. But I am not quite as sanguine as Bernanke has been.

My view is that the trade deficit is not a problem in itself but is a symptom of a problem. The problem is low national saving. Given that national saving is low, I am not eager for the trade deficit to disappear, because that would mean that domestic investment would need to fall to the low level of national saving. But I do think it would be good if the trade deficit were to disappear accompanied by an increase in national saving.

That brings me to the question of what policy can do to increase national saving. Part of the answer is that tax policy could do more to encourage private saving. I have long been an advocate of moving the tax system in the direction of a consumption tax. The Hall-Rabushka flat tax or the Bradford X tax would be ideal. But one can also do incremental reform within the current tax structure. I would, for example, vastly expand the opportunities for tax-deferred saving, such as IRAs and 401k plans. I would like to move toward allowing corporations to expense all capital investments.

I also think there is some compelling evidence coming out of the behavioral economics literature that the details of savings plans matter a lot for how successful they are. My colleague David Laibson has put together some persuasive evidence that the default is crucial. If workers are automatically enrolled in 401k plans, and have the option of opting out, participation is much higher than if workers have to actively opt-in, as is usually the case today.

The other piece of the national saving picture is public saving. A smaller federal budget deficit would mean more national saving, less reliance on foreign capital flows, and a smaller trade deficit. The trade deficit and the budget deficit are not twins, but they are cousins.

As anyone who has looked at the numbers knows, the federal government's current budget deficit is, in a sense, only the tip of the iceberg of the fiscal problems to come. The federal budget is on an unsustainable path. When the baby-boom generation retires and becomes eligible for Social Security and Medicare, all hell is going to break loose. The policy options aren't pretty—either large cuts in promised benefits or taxes vastly higher than anything ever experienced in U.S. history. The stalemate over Social Security reform that we have seen over the last year suggests that the Washington establishment is not ready for the bipartisan consensus that will be necessary to put the budget on a sustainable path.

In my view, there is plenty of blame on both sides of the aisle. The Democrats are not willing to entertain significant cuts in entitlement programs, but they are also not willing to admit that large tax increases that would be necessary to fund those programs as they currently exist. They talk as if reversing the Bush tax cuts on those making over $200,000 would solve the problem, even though the funding gap is far too large for such an easy fix. Similarly, the Republicans will not entertain talk of any tax increases, even as they expand entitlement spending with a costly bill to expand Medicare spending to cover prescription drugs.

If you were to take a poll of the American Economic Association about how to deal with the looming problem of entitlement spending, I believe that many would say that we should gradually phase in a significant increase in the retirement age. That would certainly be a large part of my preferred solution. Yet when pollsters ask the general public about the various ways to reform entitlements, raising the retirement age is one of the least popular possible reforms. This is why you don't often hear politicians talking about it.

I have frequently wondered why there is such a large gap between economists' view of raising the retirement age and the public's view. One possibility is that we enjoy our jobs more than average, so working longer seems less onerous to us than it does to other people. Another possibility, however, is that we have thought about the policy options more thoroughly than others have, and we realize that raising the retirement age may be the best of a bad lot. If that is the case, and I suspect it is, then we need to embark on a course of public education. The entitlement crunch is only a decade or two away. The sooner we act, the better.