Dealing with the Trade Deficit

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The current domestic trade debate focuses on two related but distinct problems. One is the degree to which the U.S. trade deficit affects output and employment; this is the topic we address below. A second set of arguments centers around international trade agreements, in particular the Trans-Pacific Partnership being fast-tracked in the U.S. Senate. This debate is less relevant to U.S. employment and more germane to regulatory independence and the power of corporations to override a democratic process; we address this topic at length in a series of briefs by Joseph E. Stiglitz.[i]

Regarding the U.S. trade deficit, currently equal to about 3 percent of GDP, there is growing concern that it is a drag on growth and kills jobs in America. Should U.S. policymakers seek a more favorable trade balance?[ii] Economic orthodoxy says that trade is irrelevant to GDP and employment. The textbook view is that exchange rates will automatically adjust to allow balanced trade without any effects on growth or employment. When we do see trade imbalances, in this view, they are the result of different countries making different choices about present versus future spending. Full employment will be maintained regardless of trade deficits or surpluses, either through automatic market adjustments or with the routine tools of monetary policy. In the textbook view, trade is an important microeconomic concern, in that it contributes to the efficient use of scarce resources. But at a macroeconomic level, the trade balance simply reflects underlying economic conditions; it does not play any independent role.

Whether or not this view was ever reasonable, it is clearly inapplicable today. In the U.S. and much of the rest of the world, neither market forces nor conventional economic policy are reliably maintaining full employment. Under these conditions, the trade balance has important macroeconomic effects. If there is no guarantee that the economy is operating close to potential, then we should expect a trade deficit to reduce demand and employment.

It is natural, then, to look to measures to improve the trade balance as a way to raise demand and boost output and employment—especially if fiscal policy is ruled out for practical or political reasons. The trade balance might be improved through a weaker dollar, making exports cheaper and imports more expensive, or through tariffs or other direct limits on imports. While the U.S. has done little to boost net exports in recent decades, there is increasing public discussion of such measures today. Republican presidential candidate Donald Trump has lately become the most visible advocate for tariffs, but support for a weaker dollar and other measures to improve the U.S. trade balance can be found across the political spectrum.

We argue that while the orthodox view is wrong about trade being macroeconomically neutral, measures to improve the U.S. trade balance would nonetheless be a mistake. All else equal, a more favorable trade balance will raise demand and boost employment. But all else is not equal, thanks to the special role of the U.S. in the world economy. The global economy today operates on what is effectively a dollar standard: The U.S. dollar serves as the international currency, the way gold did under under the gold standard. In part for this reason, and in part because of the depth and security of U.S. financial markets and the disproportionate weight of the U.S. in the global economy, the U.S. can finance trade deficits indefinitely while most other countries cannot. Higher net exports for the U.S. imply lower net exports somewhere else, but for many of our trade partners, any reduction of net exports would imply unsustainable trade deficits. So policies intended to improve the U.S. trade balance are likely to lead to lower growth elsewhere, imposing large costs on the rest of the world with little or no benefits here.

We do not deny that the trade deficit has negative effects on demand and employment in the U.S., but we argue this is only a reason to redouble efforts to boost domestic demand. The solution to the contractionary effects of the trade deficit is not a costly, and probably futile, effort to move toward a trade surplus, but rather measures to boost productive investment in both the public and private sector.

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i For an in-depth discussion on TPP and its flaws see Stiglitz, Joseph E. 2016. "Tricks of the Trade Deal: Six Big Problems with the Trans-Pacific Partnership". The Roosevelt Institute. March 28, 2106. http://rooseveltinstitute.org/why-tpp-bad-deal-america-and-american-workers/

ii The trade balance means total exports less total imports—a trade surplus if positive, a deficit if negative. Net exports is a synonym for the trade balance. The current account balance is a broader category that includes income payments and transfers as well as trade.

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There is a second link between trade and investment policy. One challenge in increasing public and private investment is the need for financing. Increasing investment requires new debt, which someone must hold. Here, we argue, the role of the dollar in the international financial system is an advantage. Because of the role of the dollar as the international currency, there is enormous demand in the rest of the world, especially but not only from central banks, for safe, liquid dollar assets to hold as foreign exchange reserves. This means that the demand for U.S. assets is much greater than demand for the assets of some other country offering a comparable return. This in turn means that the U.S. can borrow at much more favorable interest rates, and in greater volume, than other countries, and is not vulnerable to a "sudden stop" of financial inflows in the way that other countries are.

In the decade before 2008, this "exorbitant privilege" was used to support the expansion of housing lending. In effect, securitized mortgages were falsely sold as able to provide the safe, liquid dollar assets the rest of the world desired. The challenge now is to rewrite the rules in ways that put the U.S.'s status to more productive use.

In the short run, at least, the U.S. should not seek a more favorable trade balance, but should instead use its privileged position in the global economy as an opportunity to boost socially useful investment. In the long run, there are undoubtedly better ways to organize the global economy than a de facto dollar standard with liquidity supplied by U.S. trade deficits. These would involve some mix of international provision of liquidity and long-term finance (through a reformed International Monetary Fund (IMF) and World Bank or through new institutions) and greater space for countries to manage their trade and financial flows, so that foreign exchange reserves are less needed. Until such long-term solutions are in place, however, it would be irresponsible, costly, and probably futile for the U.S. to seek a more favorable trade balance. Fortunately, better solutions exist. Our proposals include:

- Increase federal borrowing.
- Shift from monetary policy to credit policy.
- Increase borrowing by state and local government.
- Provide loan guarantees for qualified private borrowers.
- Establish a national infrastructure bank.
- Focus on public and private "green" investment.
- Build toward a new Bretton Woods.

SHOULD THE U.S. PURSUE A MORE FAVORABLE TRADE BALANCE?

The International Role of the Dollar

Discussions of U.S. trade policy cannot focus on the trade deficit in isolation; they must take into account the special role of the U.S. in the international monetary system. As noted, under the current regime, in which the dollar serves as the world's reserve currency and the U.S. serves as the consumer of last resort, global macro-stability to some degree requires the U.S. to run trade deficits. Dollars make up 64 percent of foreign exchange reserves, according to the most recent survey by the IMF. Over the past decade, foreign central banks have increased their dollar reserves by $4.8 trillion.[1] This is almost equal to total U.S. current account deficits over the same period ($5.25 trillion). In other words, the U.S. is not so much borrowing to pay for imports as supplying a vital financial resource in exchange for them. Reserves must be held mainly in dollars for the simple reason that dollars are used in the great majority of international transactions: 87 percent of foreign exchange transactions involve the dollar and some other currency; only 13 percent of foreign-exchange contracts involve two non-dollar currencies.[2] There is no sign of any movement away from the dollar as the world currency. Both the fraction of reserves held in dollar and the fraction of international transactions using dollars are just as high today as they were 25 years ago, despite the creation of the euro in the interim.

The dollar has played this international role for decades, but the trend toward deregulation of capital flows and recurring foreign exchange crises have increased the demand for foreign exchange reserves, especially among developing countries. Jörg Bibow has described the increase in reserve holdings by developing and middle-income countries as a form of "self-insurance," the need for which has been clear since the 1997 crises. So the demand for dollar reserves, and the concomitant need to run trade surpluses, is in large part a consequence of the pressure that the U.S. put on developing countries to open up their financial markets during the 1980s and 1990s.[3]

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As mentioned above, efforts by the U.S. to shift its trade balance toward surplus, if successful, would mean that other countries would have to shift toward deficits, which many would be unable to do. Instead, they would have to impose higher interest rates and fiscal austerity, thus reducing GDP.[4] In effect, we would be subjecting other countries to more frequent balance of payments crises, or, more likely, the ultimate result would be slower growth in our trade partners and little improvement in the U.S. trade balance. There are a few other countries that might help play the U.S.'s role—mainly Germany and Japan—but they have failed to do so, leaving the burden on the U.S.

In short, the "exorbitant privilege" of being unconstrained by the balance of payments comes with an "exorbitant duty" to provide the rest of the world the insurance it needs against unexpected shifts in trade and financial flows.[5]

The flip side to trade deficits are financial inflows. As payments flow from the U.S. to the rest of the world for goods and services, payments flow back to the world to pay for U.S. assets such as government bonds. The international role of the dollar means that the U.S. pays considerably less on its foreign liabilities than it receives from its foreign assets, a privilege that has remained intact over nearly 40 years of trade deficits. This means that for the U.S., unlike most other countries, trade deficits do not lead to an unsustainable snowballing of foreign obligations. In recent decades, the return on U.S. assets abroad has been more than three points higher than the return on foreign investment here, a difference that shows no sign of diminishing over time.[6]

Because of both the special international role of the dollar and the size, depth, and security of U.S. financial markets, the U.S. is the favored outlet for the "global savings glut" famously described by former Fed chair Ben Bernanke.[7] As Bernanke noted, anticipating today's "secular stagnation" debates, the global savings glut implies persistently low interest rates, especially in the U.S. This creates a great opportunity for anyone who is able to supply safe, liquid, dollar-denominated assets at the scale the rest of the world demands. Instead of using the exorbitant privilege of the dollar to finance an unsustainable real estate boom, as it did in the 2000s, we could put that privilege to use for better ends, both through the guaranteed global market for U.S. bonds and by channeling cheap, abundant credit to private borrowers.

Are U.S. Trade Deficits Sustainable?

Some suggest the special status of the dollar could be endangered by continued deficits, i.e., that foreign investors might flee from the dollar in a crisis. There is strong evidence, however, that these worries are misplaced.

First, in most countries that run sustained deficits, the danger is that interest payments on the accumulated foreign debt eventually become unsustainable. But the U.S., despite 30 years of trade deficits, still receives much more income from its assets in the rest of the world than it pays to its foreign creditors. In 2015, U.S. net investment income was over $200 billion, and this positive income is growing over time. So the trade deficit is not creating any financial burden, and is sustainable in a way that it would not be for other countries.[8]

Second, if foreign investors were worried about excessive U.S. borrowing, that should show up in market prices as either rising interest rates or a declining value of the dollar. But the reality has been just the opposite. During the crisis of 2008–2009, there was a flight to the dollar, which increased in value by 20 percent despite the fact that the crisis was centered in the U.S. This was the opposite of what had been predicted by those worried about "unsustainable" U.S. borrowing. And even if investors wanted to move away from the dollar as the international currency, there is no plausible alternative; the euro, which was once the most plausible candidate, faces an ongoing crisis and may not even exist 10 years from now.

A third problem with the "sudden stop" scenario is that these crises have occurred historically in countries with a great deal of public and/or private debt denominated in foreign currencies. But the great bulk of U.S. liabilities to the rest of the world are denominated in dollars. This means that as soon as any outflow produces a depreciation of the dollar, the U.S. financial position automatically improves. As long as this is the case, it is not possible for the U.S. to face an external constraint, since any reduction in the willingness of the rest of the world to lend to us just results in a reduction in the value of our existing liabilities. And, of course, the fact that U.S. external liabilities are denominated in dollars means that there is no possibility of default—which means there is no reason for runs.

The bottom line: Because the dollar functions as the world reserve currency, the U.S. can run a large trade deficit indefinitely without increasing interest rates or other financial consequences. The U.S. can offset the negative demand from a trade deficit with increased domestic demand; most other countries cannot.

POLICIES TO BOOST DEMAND AND EMPLOYMENT: USING CAPITAL INFLOWS

The facts that the trade deficit can be offset by increased domestic demand, and that foreign demand for dollar assets can be channeled into productive investment, does not guarantee it will actually happen. On this point, the anti-trade critics are right, and the establishment view is too complacent. The solution, however, need not be policies to reduce the trade deficit. Instead, it can be policies to channel foreign lending into uses that both boost demand and employment and serve broader public interests. The most straightforward way to do this is for the federal government to replace the financial system as the link between foreign lenders and the U.S. economy, borrowing directly in order to increase public investment. For various reasons, however, it may be preferable to support private spending instead.

Increase Federal Borrowing

The federal government can use cheap credit to fund public works.

The most straightforward way to finance socially valuable investment is for the government to carry it out directly. While the federal budget process is not always straightforward, in principle public investment allows choices about spending priorities to be made in a transparent, democratically accountable way. If, as a number of economists have suggested, the world suffers from a safe asset shortage, why shouldn't the U.S. federal government, as the biggest producer of safe assets, step in to fill the void? Bibow has observed that the natural route to sustaining aggregate demand would be to "boost public spending with a focus on infrastructure investment," noting that "private debt-financed consumer spending as the counterpart to the U.S.'s external deficit, is dead and cannot easily be revived, but a [new] regime may come to take its place, featuring continued U.S. current account deficits, this time driven by public spending and public debt."[9]

But while increased federal borrowing is the most natural solution, it may also be desirable to improve financing for private investment. This is especially important insofar as the size of the U.S. government debt is seen, rightly or wrongly, as a constraint on policy.

Shift from Monetary Policy to Credit Policy

The Federal Reserve can target credit to productive institutions such as municipalities.

The Federal Reserve could expand the monetary policy tool box to boost demand through direct lending to socially useful entities rather than relying on the financial markets as intermediaries. Specific steps here would include: selectively purchasing the liabilities of economic units engaged in socially useful investment and facing significant credit constraints, such as municipal bonds; pushing banks to increase lending to the same set of units, for instance by taxing excess reserves; the Fed directly lending to a wider range of borrowers, as it did briefly in the commercial paper market during the fall of 2008; setting targets for a wider range of interest rates; and setting targets for credit growth both in the aggregate and for specific sectors. This sort of "credit policy" has been practiced by many central banks historically, including central banks in both developing and advanced countries.[10] One particularly successful example of directed credit by the central bank is Japan during its postwar boom.[11] A number of economists have described the advantages of a broader credit policy over conventional monetary policy.[12]

Such policies could also include supporting municipal borrowers. In particular, the Federal Reserve should study and make recommendations on its ability to aggressively use its existing authority to purchase short-term municipal debt, and the effectiveness of supporting municipal debt markets using that approach. It is hard to understand why a lack of financing should lead to catastrophic cuts in local services when the country as a whole enjoys abundant liquidity.

This discussion is largely motivated by concerns that conventional monetary policy has proved ineffective in stabilizing aggregate demand, and that low interest rates lead to asset bubbles and other distortions. Connected with this is an increasing recognition that monetary policy inevitably affects relative prices and the direction as well as level of economic activity, including the distribution of income.[13] While not explicitly addressed to the trade balance, these new ideas about monetary policy dovetail nicely with the idea that the international role of the dollar implies persistent U.S. trade deficits but also great demand for U.S. assets. This implies a shift in the focus of monetary policy toward the quantity and direction of credit rather than its price.

Increase Borrowing by State and Local Government

Provide state and local governments with cheap credit to invest in long-term projects.

One specific piece of a shift from monetary policy to credit policy would be support for increased borrowing by state and local governments. In the U.S., the majority of infrastructure and education spending happens at the state and local level, so any program to channel financial flows into productive investment needs to include increased municipal borrowing. State and local governments themselves should also reevaluate their current fiscal positions and explore ways to use the low-interest environment to expand investment in physical and human capital.

Today, most state governments are constitutionally prohibited from running operating deficits but committed to funding a certain set of programs and services. State and local governments also hold large asset positions outside of pension funds; most state governments are substantial net creditors, as is the sector as a whole. State governments generally shifted toward net asset positions during the 1980s, and at a time in which interest rates were well above growth rates, this commitment to avoiding debt and to prefunding had a clear logic to it. But in the current environment, it is counterproductive. Municipal governments would be better off with more borrowing and less prefunding; when risk-adjusted returns fall below growth rates, it is cheaper to fund pensions on a pay-as-you-go basis, especially given the high fees state and local governments have historically paid to the managers of their pension funds. (See our section on municipal finance for more.) In a low-interest environment, more debt and less prefunding is fiscally sensible, and, importantly for present purposes, it will help support aggregate demand.

Provide Loan Guarantees for Qualified Private Borrowers

To seed desirable private projects, the federal government can offer a cushion against losses.

Loan guarantees are a commitment to absorb some fraction—typically 50 to 90 percent—of the losses from defaulted loans to designated borrowers. They are a natural tool to allow the federal government to use its status as a privileged borrower to support credit flows to private businesses. The value of loan guarantees comes from the existence of pervasive information problems in private credit markets. In a world of perfect information, a loan guarantee would simply be a subsidy. But because of information problems in credit markets, there are a number of loans that are not made even though they would offer positive private returns. By offsetting the risks created by information asymmetries, a loan guarantee program can support increased lending with private and social returns much greater than the required outlay of public funds. One recent study of loan guarantee programs suggests that it is reasonable to expect an annual default rate of 10 percent and a recovery rate of 50 percent. Given these assumptions, a program covering 80 percent of default losses could support $20 billion in increased loans with an outlay of $590 million per year. The program would therefore cost the federal government 2.9 cents for every dollar of private loans extended.[14]

Establish a National Infrastructure Bank

Funnel international capital flows into transformative public investment.

An infrastructure bank is a natural channel to direct credit to socially useful private borrowing.

One specific mechanism to improve financing for state and local investment is a national infrastructure bank. Such a bank would make long-term loans to state and local governments, public–private partnerships, and perhaps private businesses to finance infrastructure investment. The federal government would provide initial capital, and the bank would be publicly owned, but going forward it would finance itself by issuing its own bonds. An infrastructure bank would encourage public investment by offering more favorable terms than private lenders, especially for smaller and financially weaker borrowers. It would be a hub for national planning around infrastructure investment. Just as important for present purposes, the bonds issued by the bank would help satisfy the world's demand for safe, liquid dollar assets.[15]

Focus on Public and Private "Green" Investment

Funnel international capital flows into low-carbon public investment, such as building retrofits.

Both public and private investment should be focused in "green" sectors—development of non-carbon energy and increased energy efficiency. One particularly promising area is building retrofits. Most energy consumption is associated with buildings, and there are straightforward modifications that can greatly reduce energy use, especially for older buildings. For an average-sized single-family home in the United

States, an investment of as little as $2,500 in energy-efficiency retrofits can reduce energy consumption by 30 percent. These kinds of investments also tend to support more employment than many other forms of expenditure. Building retrofits have been estimated to produce seven direct jobs and five indirect jobs for each $1 million in spending.[16] Because these retrofit projects combine upfront costs with savings over a long future period, they are natural candidates for debt financing. But the dispersed building owners, the information problems, and, in the case of commercial structures, the transaction costs often created by the separation of ownership from liability for utility bills means that there is a natural role for a public agency in channeling loans into retrofits.

Build Toward a New Bretton Woods

Replacing the dollar standard with a genuine international currency would reduce foreign dependence on exports to the U.S.

To the extent that we do want a more favorable trade balance, the focus needs to be on reducing the rest of the world's need for dollar reserves rather than boosting U.S. competitiveness. In the long run, this could mean the creation of a new international financial architecture, along the lines of the Bretton Woods agreements 70 years ago.[17][18] This is not a solution in the short run, and raises difficult questions about the goals as well as the mechanics of a new system. But in the long run, the only way to wean the world off its dependence on exports to the U.S. is to replace the de facto dollar standard with a genuine international currency.

In the absence of such global reforms, the U.S. government could take steps now to reduce the need for reserve accumulation abroad. It could reverse its opposition to capital controls (restrictions on cross-border financial flows), as its current commitment to a universal regime of free financial mobility does not serve any obvious public interest. That commitment leads to a greater need for foreign exchange reserves, mainly dollars, by increasing our trading partners' vulnerability to changing sentiments in financial markets. In effect, by discouraging countries from taking steps to protect their foreign exchange, the U.S. has put them in a situation where they have a strong national interest in accumulating dollars via trade surpluses. The IMF has recently expressed some limited support for capital controls.[19] The U.S. should encourage the IMF to carry this rethinking further and abandon its support for capital account liberalization.

The Fed could also extend swap lines to a greater range of foreign central banks. Swap lines are commitments by a pair of central banks to trade their respective currency on demand. The purpose is to "to improve liquidity conditions in dollar funding markets ... by providing foreign central banks with the capacity to deliver U.S. dollar funding to institutions in their jurisdictions during times of market stress."[20] The Fed has standing legal authority to enter into swap agreements with foreign central banks, and has already used this authority both to offer emergency dollar liquidity to a large number of central banks in the crisis and to create permanent, open-ended swap lines with a small number of central banks in developed countries.[21] By guaranteeing access to dollars in an emergency, swap lines would reduce the need for "self-insurance" through reserve accumulation, especially if the agreements were extended to central banks in middle-income countries.[22]

Neither extending swap lines nor supporting capital controls would have an immediate effect on the U.S. trade balance, but over time, these measures would remove some of the structural factors that make the trade deficit so resistant to conventional measures to boost net exports.

CONCLUSION

The trade balance in itself is not a problem for the U.S. If trade deficits reduce demand and employment, that is only because we lack the the necessary institutions to channel the corresponding financial inflows into productive investment. Developing these institutions is the best response to understandable pressures for protectionism.

More broadly, trade policy poses a fundamental challenge. Domestic goals like full employment must be the responsibility of our elected government. But at the same time, the U.S. cannot ignore its role in the international monetary system. This tension between democratic legitimacy, which remains national, and the reality of a global economy does not have any straightforward solution. A balance must be struck in each particular case.[23] For the U.S. today, in our view, an appropriate balance requires foregoing policies to improve the U.S. trade balance; instead, we must develop policies that jointly address the U.S.'s need for strong demand and full employment and the rest of the world's need for dollars by channeling foreign capital into productive, job-creating domestic investment.

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