Opinion **Trade disputes**

Targeting specific trade deficits is a game of whack-a-mole

It is a fallacy that countries lose out unless their exports exceed their imports

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Restricting aluminium imports would hurt US aircraft exports © Bloomberg

Maurice Obstfeld APRIL 22, 2018

Fears of escalating trade disputes hung over last week's IMF-World Bank spring meetings.

The US has an overall trade deficit with the rest of the world and its leaders would like it to be smaller. For that to happen, however, trade partners must reduce their collective surplus with the US — a task made more difficult as American spending and imports surge after the recent tax cuts and increase in government spending. This stand-off could derail the world economy's current expansion, especially if more countries turn to trade restrictions.

Countries' overall trade deficits can of course be excessive — as can surpluses. That is why the IMF points out when these balances get out of line in either direction. But it is an age-old fallacy to believe countries lose from trade unless their total exports exceed their imports. Deficits often play a vital economic role. For example, they can help countries finance productive long-term investments that ultimately raise national income and wealth.

As wrong as it is to equate a country's trade gains with its overall trade surplus, it is an even worse mistake to think that a country loses from its trade with a specific partner because there is a bilateral deficit. The overall trade balance is the sum of all the bilateral balances — some negative, some positive — but the benefits from trade do not come only from the surplus relationships. Indeed, if a country seeking a smaller overall deficit mistakenly puts up import barriers, it would force its bilateral surpluses to shrink along with its deficits.

A country's overall trade balance is a macroeconomic phenomenon that mirrors whether it spends less than its income or more. In contrast, the structure of bilateral trade reflects the international division of labour — based on each country's comparative advantage.

The US imports aluminium, for example, which contributes to its trade deficit with China. But cheaper aluminium imports facilitate one of the US's biggest and most distinctive exports: aircraft. Restricting aluminium imports would not only hurt aircraft exports, it would make the global division of labour less efficient. The restriction would not alter the fact that the US spends more than it earns — the source of the overall US deficit.

US policymakers are trying to negotiate down its trade deficits with specific partners, such as Mexico, South Korea and China. They say they are trying to fix policy distortions in the bilateral trading relationships and raise the overall US trade surplus. The first goal, where distortions exist, may redress inequities and raise global production efficiency.

But the US is unlikely to improve its overall trade balance, even if it manages to reduce some bilateral deficits. Suppose South Korea agrees to limit its steel exports to the US while lowering barriers to imported US cars. Lower US steel imports from Korea and higher auto exports to Korea might well be accompanied by higher steel imports from, say, Canada and lower auto exports to Australia.

Alternatively, if the US does end up producing more steel and cars itself, that could come at the cost of producing fewer other export goods — a strong possibility for a country at full employment, like the US. Any reduction in America's trade deficit with Korea would just be replaced by bigger deficits and smaller surpluses with other trade partners, as in a game of whack-a-mole.

Changes to bilateral trade need not alter national imbalances between spending and income. That requires countries to adopt policies aligning their spending levels more closely with their incomes. Instead, if taken too far, a focus on bilateral trade can badly distort the international division of labour — thereby reducing the benefits all countries derive from trade. Even when bilateral action reflects well-founded complaints, it may still draw retaliation.

A multilateral approach that strengthens the current rules-based system of dispute resolution is far preferable. It would enable mutual gains while avoiding trade wars in which the only victories are Pyrrhic.

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The aggregate current account surplus of the developing world has fallen to its lowest level since the 1990s, even as tensions over trade imbalances have fed fears of looming trade wars.

The emerging world chalked up a current account surplus of just 0.6 per cent of gross

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