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Bilateral Trade Actions Trumped by Insufficient US Savings

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ABSTRACT

The US trade deficit with China was \$336 billion in 2017, representing more than half the overall US trade deficit (Census, 2018). So, it is no wonder that policymakers, the press, and the public are focused on this trade relationship. The Administration has stepped up its criticism of China and imposed tariffs in response to unfair trading practices regarding intellectual property (Price, 2018), and China's reluctance to open markets to US producers. The Administration has also engaged in trade spats with Mexico, Canada, Japan, Germany, and others. While the goals of protecting US intellectual property rights and expanding export markets are laudable, the President's emphasis on eliminating bilateral trade deficits with China and other nations as a means to solve the overall deficit is doomed to fail (Tyson, 2018). This paper makes the following observations: (1) Balancing trade with China and other nations would not correct the overall US trade deficit, as the massive deficit is entirely due to insufficient domestic saving (2) The Administration's recent decisions to cut taxes and increase government spending will likely worsen the trade deficit. (3) The widening deficit with China reflects shifts among Asian producers and has not expanded the overall US trade deficit.

Keywords

Trade policy, China, bilateral trade deficits, budget deficit, national saving

1 INTRODUCTION – WHAT NEGOTIATIONS CAN AND CANNOT DO

The explicit goals of the Administration's approach to trade are to address intellectual property theft by China (White House [1], 2018), expand export markets for US manufacturers, and correct bilateral trade imbalances (White House [2], 2018). Implicitly, the Administration's focus on correcting bilateral trade deficits suggests a desire to narrow the overall trade deficit in a piecemeal fashion. Successful negotiations for the first two goals could pay important dividends for US businesses (Ip, 2018). The last goal is not likely to work.

The Chinese have been appropriating US technology and intellectual property for decades. Lewis (2018) describes the many ways the Chinese have obtained US intellectual property through the use of corporate espionage, cyber theft, and "forced technology transfers or mandatory joint ventures as a condition for doing business in China." The White House (2017) estimates that the total cost of these practices to the US could be \$600 billion over the past two decades. Attempts to level the playing field with China with respect to intellectual property would allow US companies to reap the rewards for their own innovations. In addition, any effort to open export markets, especially a huge untapped market like China with its 1.4 billion people, would be beneficial to US producers.

It appears that the Administration's trade actions aim to reduce the overall trade deficit by correcting bilateral imbalances with those nations where the US runs the biggest deficits. According to Census (2018) data, the US runs large bilateral trade deficits with a number of countries, including China (\$348 billion), Mexico (\$70 billion), Germany (\$69 billion), and Japan (\$58 billion). When a trade imbalance is skewed heavily toward one nation or set of nations, as is the case of the US trade deficit today, the temptation is to try to "fix" those relationships as a means of reestablishing overall balance. Indeed, the President has focused on these bilateral trade deficits when formulating US trade actions. For instance, China was asked explicitly to unilaterally reduce the deficit with the US by \$200 billion (Lawder, 2018). The President also used the wide deficit with Mexico as a reason to call for revamping the NAFTA agreement (Trump, 2018). This approach is not new. More than three decades ago when faced with a widening trade deficit, the US tried a similar strategy of negotiating directly with Japan, known as Market-Oriented Sector-Selective (MOSS) talks, to eliminate its trade barriers and correct the wide bilateral trade deficit (GAO, 1988).

However, just as the MOSS talks did little to lower or even slow the widening of the overall trade deficit in the mid-1980s, focusing on correcting bilateral trade deficits today will not improve the overall balance in the US trade accounts. The forces that drive the

imbalance with China and other nations are different than the forces that drive the overall US trade deficit. Fixing bilateral imbalances would only cause the deficit to reemerge somewhere else, unless the root cause – the lack of US saving – is addressed.

2 SHORTAGE OF US SAVING

The US trade deficit is ultimately generated by the extremely low savings rate in the US. More than a decade ago when the trade deficit was beginning to expand sharply, Gregory Mankiw (2006) stated “that the trade deficit is not a problem in itself but is a symptom of a problem. The problem is low national saving.” This lack of saving is still true today. For example, in 2017, according to the Bureau of Economic Analysis saving and investment account (2018), the US private sector saved \$1.520 trillion, or 7.8 percent of GDP, split between consumer saving from after-tax income (\$987 billion) and business saving in the form of undistributed or retained earnings (\$533 billion). Meanwhile, the government dissaved (spent more than its tax revenues) and ran a massive \$955 billion budget deficit, or 4.9 percent of GDP. So, total combined saving of consumers, businesses, and government was \$566 billion (net of depreciation), which was just 2.9 percent of GDP. In effect, the government is absorbing (borrowing) two-thirds of all the private saving in the economy to finance its deficit, leaving little for other priorities such as business capital investments. Domestic investment spending in the US was \$895 billion in 2017 or 4.6% of GDP, making it necessary for the US to tap foreign sources of saving to make up the difference (see **Figure 1**).

Figure 1: US Saving and Investment Account

Net Saving	\$566	2.9%
Net Private Saving	1,520	7.8
Domestic Business	533	2.7
Households	987	5.1
Net Government Saving	-955	-4.9
Net Domestic Investment	\$895	4.6%
Net Private Investment	793	4.1
Domestic Business	507	2.6
Households	286	1.5
Net Government Investment	102	0.5

Source: Bureau of Economic Analysis, NIPA, Table 5.1.

That is where the trade deficit comes in. If there is little total domestic saving because of huge dissaving by the government, then US investments must be financed by funds coming from outside the US. This is shown in the standard Keynesian (1936) macroeconomic equilibrium equation, which has been expanded to include government and foreign sectors (see Salvatore (2016) for a thorough explanation of this relationship).

$$(M - X) = (I - S) + (G - T)$$

where M is imports, X is exports and (M - X) is the trade deficit; I is investment, S is private saving and (I - S) is the excess of investment over private saving (or the private borrowing need); and G is government spending, T is tax revenues and (G - T) is the budget deficit (or government borrowing need). In other words, the borrowing needs of the private sector and the government sector (the right-hand side of the equation) will be met by the foreign sector (the left-hand side of the equation).

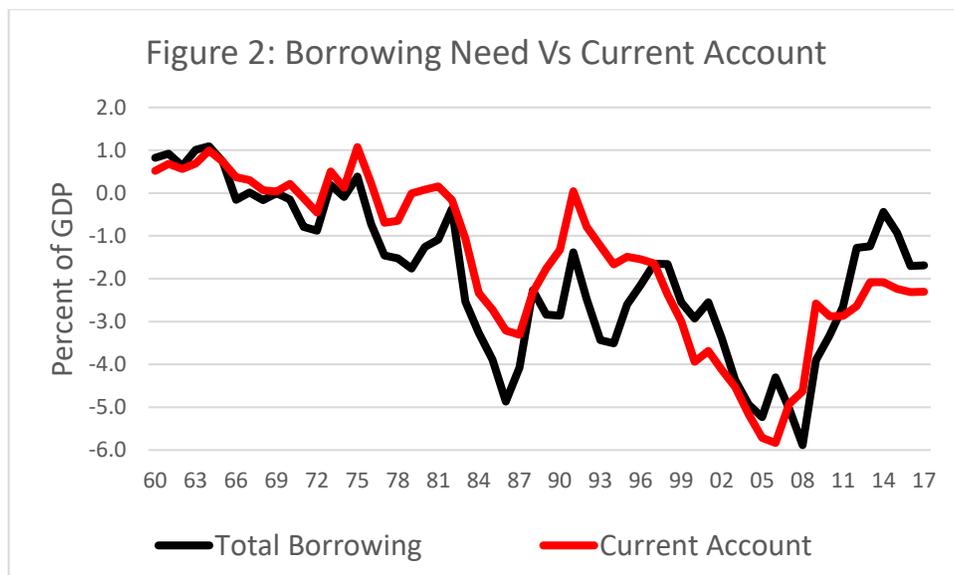
How does the trade deficit finance the US private investment and government deficit? For every trade transaction, there is an equal but opposite financial account transaction. For example, when a US citizen buys something from abroad, he/she initially pays dollars to receive goods and services. Those dollars are exchanged for foreign currency and then sent back to the US as asset purchases. In other words, foreigners loan the money back to the US in the form of investments. In effect, foreigners lend the US the dollars that are used to buy foreign products.

It is clear from the equation that there is a direct relationship between the size of the budget deficit (G - T) and the size of the trade deficit (M - X). That means the government can reduce the trade deficit by lowering the public sectors' need to borrow. The choices for how to do this are limited: (1) raise taxes or (2) cut government spending. Since there also is a direct relationship between the private sector's need to borrow (I - S) and the trade deficit, the government could also pursue policies that (3) increase

private savings or (4) reduce investment spending. None of these four options is very appealing to policymakers or the public because they all involve contractionary policy, which would lower GDP growth.

There is a fifth possibility – abandoning the long-standing “strong dollar” policy and allowing a sharp depreciation of the dollar. Based on results of an OECD (2004) study, it would take about a 30 percent depreciation of the broad trade-weighted dollar to alter the terms of trade enough to close the trade deficit (which according to the BEA-Table 1 (2018) is currently 2.8 percent of GDP). Importantly, a policy decision to devalue the dollar would likely result in a sharp increase in the inflation rate and a jump in interest rates, which in turn would lower the private sector’s borrowing need by decreasing investment spending and increasing savings. It would also likely slow the pace of US economic growth as well.

Notice that the cause for (and the solution to) the trade deficit is determined by the need to borrow funds within the US. If there is a shortfall of domestic saving, the US must get the funds it needs from foreign sources. It obtains those funds while simultaneously providing them to foreigners in the form of a trade deficit. **Figure 2** shows the close relationship between BEA-Table 5.1 (2018) data on the total domestic borrowing need (the government deficit plus the excess of investment over private savings) and BEA-Table 1 (2018) data on the trade deficit (current account) as a percent of GDP.



3 FISCAL POLICY AND THE TRADE DEFICIT

The US necessity to borrow funds from abroad stems largely from its government budget deficit, which totaled \$955 billion in 2017. The Federal government ran a \$695 billion deficit and state and local governments ran a shortfall of \$259 billion (BEA-Tables 3.1-3.3, 2018). These budget deficits represent the total US government borrowing need and diminish the amount of saving available for domestic investment. In other words, domestic savers (lenders) only partially fund business investment and the budget deficit. Foreigners must provide the rest. To reduce its trade balance with the rest of the world, including China, the US must pursue policies that increase domestic savings. The most direct way to raise domestic saving is to reduce the US budget deficit.

Against this backdrop, the Federal government recently embarked on a \$140 billion per year expansion of government spending for the next two years, after cutting taxes by \$150 billion per year for the next decade (CBO, 2017). The net effect will be a \$290 billion increase in the budget deficit in each of the next two years and substantial increases thereafter. As a result, the CBO (2018) has calculated that the Federal budget deficit will top \$1 trillion by 2020. Moreover, the Committee for Responsible Government (2018) makes the case that the increases in government spending will be made permanent, further expanding the budget deficit.

Where will that money come from? There is no reason to expect US consumers to save more, nor can US businesses be expected to invest less. In fact, the tax cuts could actually boost domestic investment. The money to finance this expansion of the budget deficit and any additional investment most likely will be supplied by foreign investors. If so, the US should expect a sizable increase in the trade deficit, including a larger deficit with China.

Bottom line: Pursuing policies to simultaneously narrow the trade deficit (impose tariffs) and expand the budget deficit (tax cuts and spending increases) is counterproductive, since these deficits are actually tied together – the trade deficit helps finance the

budget deficit. The budget deficit indicates a need of the government to borrow funds, and the trade deficit gives foreigners the means (dollars) to supply those funds. Lowering the trade deficit makes it harder to finance the budget deficit; conversely, expanding the budget deficit means that a wider trade deficit will be needed to finance government borrowing.

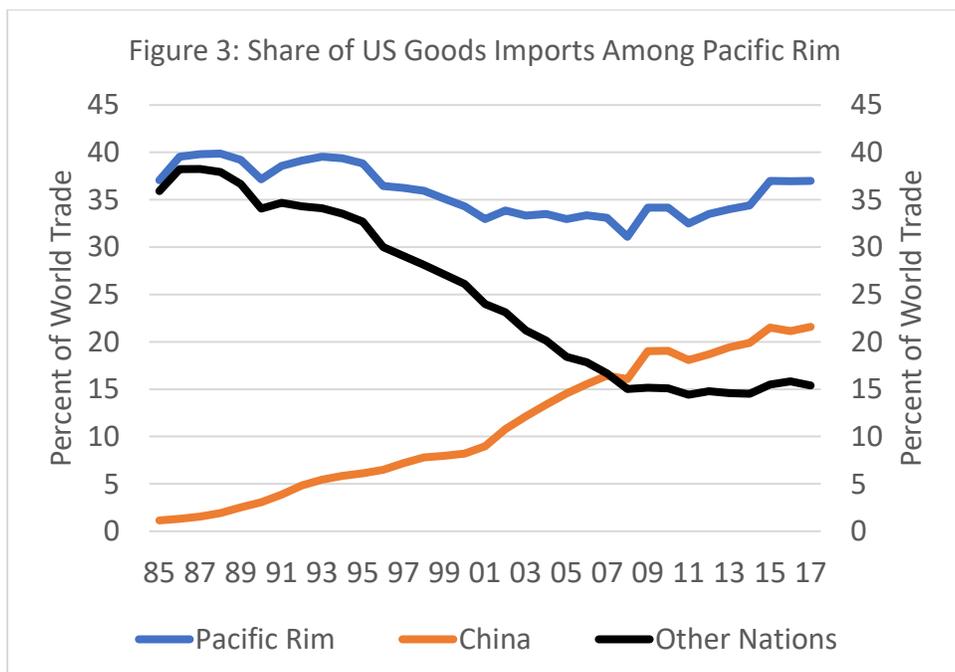
4 EVOLVING TRADE IMBALANCES

While the bilateral trade deficit with China has increased by 50 percent in the past decade, the overall US trade has not changed at all (Census, 2018). This divergence suggests that the bilateral trade statistics are masking other important changes in trade with other nations. Specifically, the production processes of light manufacturing products have been evolving over decades, with nations specializing in those parts of production processes for which they have a comparative advantage.

For instance, the US has been buying consumer goods for decades from Asian nations, including China, Hong Kong, Indonesia, Japan, Singapore, South Korea, Taiwan, and Thailand. Figure 4 shows that Pacific Rim nations have traditionally accounted for approximately 37 percent of all US goods imports (Census, 2018). Pacific Rim nations have large semi-skilled labor forces and access to mid-level technology. This has given them a strong advantage in production that uses those types of labor and technology resources, such as light manufacturing. US consumers have benefited from trade with Pacific Rim nations by purchasing their manufactured goods more cheaply than they could from US producers.

Many Asian manufacturers moved production processes to China to lower their costs even more. China has a much larger semi-skilled workforce than its neighbors, so it has a natural advantage in some aspects of production. China also has invested heavily in plant and equipment that allow its workers to fulfill light manufacturing tasks (especially processing parts into final products) more easily and cheaply than any other nation. As a result, final production has shifted to China, whether it be through outsourcing or offshoring, from other Pacific Rim nations (Salvatore, 2016). Sirkin (2016) describes the shift in light manufacturing centers as part of an ongoing process, which will eventually move away from China to other low-cost areas as the Chinese move toward higher-end manufacturing.

Although the share of US imports that come from Pacific Rim nations has been relatively constant for the past 30 years, the national origin of those imports has evolved sharply. In the late 1980s, China represented less than 2 percent of US imports, and now its share of imports is more than 20 percent. Meanwhile, other Pacific Rim nations' share has declined sharply, from about 36 percent in the late 1980s to about 15 percent now. Specifically, Japan represented over a 20 percent share of US imports in the late 1980s, but that share has dropped to about 6 percent. These percentages come from Census (2018) data and are depicted in **Figure 3**.



China actually runs a balanced trade account versus its Asian trading partners, as those nations ship semi-finished parts to China for final assembly (China Customs, 2018). At least 40 percent of the US trade deficit with China is made from parts produced outside of China (Roach, 2018). Since China doesn't ship the products back to those nations, China's trade figures appear one-

sided in favor of those other Asian nations. Meanwhile, China sends the finished products to the rest of the world, creating a huge Chinese trade surplus with non-Pacific Rim nations, especially the US. Since the last step in the production process takes place in China, the products are counted in the US as Chinese imports. This technicality is ballooning imports from China at the expense of imports from other Asian nations, especially Japan.

The same story has been playing out in North America, as light manufacturing portions of US production have been increasingly outsourced to Mexican maquiladoras, or processing plants (Castillo, 2018). Maquiladoras mostly assemble final products in Mexico which are then exported to the US. Only a fraction of the value added created in these plants is actually Mexican-made. According to Castillo (2018), Mexican content slipped from 27 percent in 1981 to just 13 percent in 2006. Nevertheless, the entire value of the products is counted as US imports from Mexico.

5 CONCLUSION – BILATERAL DEFICITS IN A GLOBAL ECONOMY

Robert Reich (1991) stated nearly 30 years ago that the individual country stamp on imported products becomes meaningless as production processes become increasingly global. That is even truer today, especially in trade with China and Mexico. Products that the US imports contain parts that were made in the US; products that the US exports contain components made elsewhere. The same can be said for products traded to and from every other nation, including China. The bottom line is that bilateral deficits do not tell the whole story about trade in the modern age. Moreover, these bilateral deficits and surpluses are not the driving force behind the overall US trade deficit. The deficit is caused by a shortfall of national saving, most notable the excessive dissaving by the US government, which in turn means that US investment must be financed by foreign saving. The Administration exacerbated this saving shortfall recently by cutting taxes and increasing government spending. The net effect of these actions will be a bigger budget deficit and a wider trade deficit, regardless of any changes in the bilateral deficits.

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