

Testimony before the U.S. Department of Commerce on causes of significant trade deficits for 2016

Testimony • By Robert E. Scott • May 18, 2017

Comments Regarding Causes of Significant Trade Deficits for 2016

Robert E. Scott

Senior Economist and Director of Trade and Manufacturing Policy Research
Economic Policy Institute

Countries Referenced: China, Canada, Germany, Italy, Japan, Korea, Mexico, Netherlands, Russia, Singapore, Switzerland, Taiwan, and Vietnam

Thank you for allowing me to testify here today. Executive Order 13786 calls for a review of U.S. trade policy and its potential to harm U.S. workers. This examination is welcome and long overdue. However, the specifics of the review offered by the President mean that it is likely to fail to provide any help to American workers, in part because it asks the wrong questions.

The Order requires Secretary of Commerce, the USTR and the Secretaries and heads of other Departments and Agencies to “identify every form of trade abuse and every nonreciprocal practice that contributes to the U.S. trade deficit.” The report is to be completed within 90 days, with an analysis of the detailed cause of the deficit “by country and major product.” But the trade deficit is not a “product by product” or a “country by country” problem. We know what it is caused by and what should be done about it.

I would like to call your attention to the following points regarding the subjects of today’s hearing:

- **Major causes of the trade deficit.** Unfair trade, currency manipulation and currency misalignment have placed the commerce of the United States at an unfair disadvantage. Increases in exports support demand for domestically produced goods, and increase domestic employment. Increased imports reduced demand for domestically produced goods and reduce domestic employment. Hence, changes in the trade balance are the best overall measure of the net impact of trade on the output of domestic trade goods, and on employment in those industries.
- **Consequences of unfair trade.** Growing trade deficits with China and other surplus countries have eliminated millions of jobs in US manufacturing in the past two decades (Scott 2017a, Scott and Glass 2016). Overall, 5.2 million manufacturing jobs were lost between January 1998 and April 2017, a decline of 29.6 percent (Bureau of Labor Statistics 2017).
- **Effects on U.S. production capacity.** Growing trade deficits were the most important cause of declining manufacturing employment, which resulted in a decline in U.S. manufacturing production capacity of roughly one-third in this period.
- **Effect of mercantilist policies.** Countries that have engaged in systematic currency manipulation (such as China), or which have maintained persistently undervalued exchange rates through other means (such as Germany), are engaged in mercantilist behavior which has effectively exported unemployment in manufacturing and other traded goods industries to the United States and other deficit countries (Scott 2014, 2015).

- **Role of non-market economies.** Non-market economies such as China and Vietnam have contributed to growth of global trade imbalances, and to bilateral deficits with the United States. The U.S. should continue to treat these countries as non-market economies in fair trade enforcement proceedings.
- **Impacts of overcapacity.** Extensive government subsidies and the rapid growth of state-owned enterprises have generated a massive buildup of excess capacity in a range of Chinese industries. Excess capacity means that China's factories are churning out massive quantities of basic commodity products such as steel products, aluminum, machinery, rubber and plastics and stone, cement, glass, and solar panels that far exceed the demand for these products in China's domestic economy. To prop up these overcapacity industries, these products are sold in other markets at below market rates (dumping). The United States bears a uniquely large burden, suffering more than other countries from subsidized and dumped imports in these industries (Brun 2016, U.S.–China ESRC 2016, 105).
- **Role of Subsidies and SOEs.** Much of this Chinese overcapacity has been developed by SOE's, which channel financial support to companies in these industries through state banks (U.S.–China ESRC 2016, 103). But direct support from the Chinese government in the form of subsidized prices for energy and natural resource inputs also plays a significant role (Haley 2008, 2009, 2012).
- **Impacts of FTAs.** Free Trade Agreements have encouraged multinationals from the United States and other countries to outsource production to other countries for sale in the United States. FTAs have also failed to stimulate U.S. export growth, resulting in rapidly growing trade deficits and trade-related job losses (Scott 2011, Scott 2016).
- **Other factors.** Widespread government intervention in China and other mercantilist economies is so pervasive that it is no longer possible to remedy these problems through targeted trade enforcement. Subsidies, dumping and excess production have so distorted production costs in a wide array of industries, ranging from electronics and industrial machinery to metal products of all kinds, automobiles, aircraft and other transportation equipment, and all kinds of industrial products that it will be impossible to put the evil genie of unfair trade policies back in its bottle through fair trade enforcement policies alone. Currency realignment provides the only tool available that is broad and powerful enough to provide redress for a generation or more of pervasive, widespread unfair trade policies (Scott 2017b).
- **Product and country specific trade policies are unlikely to have a significant impact on U.S. trade deficits.** Product- and country-specific trade remedies will not have a significant impact on the overall U.S. goods trade deficit, or on total manufacturing output or employment. Addressing the causes of bilateral trade deficits at the country or product level generally involves the use of tariffs or other trade penalties or barriers to reduce or eliminate unfairly traded imports, or to open markets to U.S. exports or to eliminate other unfair trade practices (e.g. technology theft). However, recent economic research has convincingly demonstrated that raising tariffs has little or no impact on the overall balance of trade, which is determined by overall savings and investment flows at the macroeconomic level (Gagnon 2017). Gagnon cites as an example a hypothetical ban on iron and steel imports, which totaled \$34 billion in

2016. If overall household savings and business investment do not change, then the dollar will rise by slightly more than 1 percent, sufficient to increase imports and reduce exports of other products so as to leave the trade balance unchanged. If the overall trade deficit is not reduced by the hypothetical ban on steel imports, then the overall number of jobs displaced by trade, and the level of total manufacturing output, will remain unchanged.

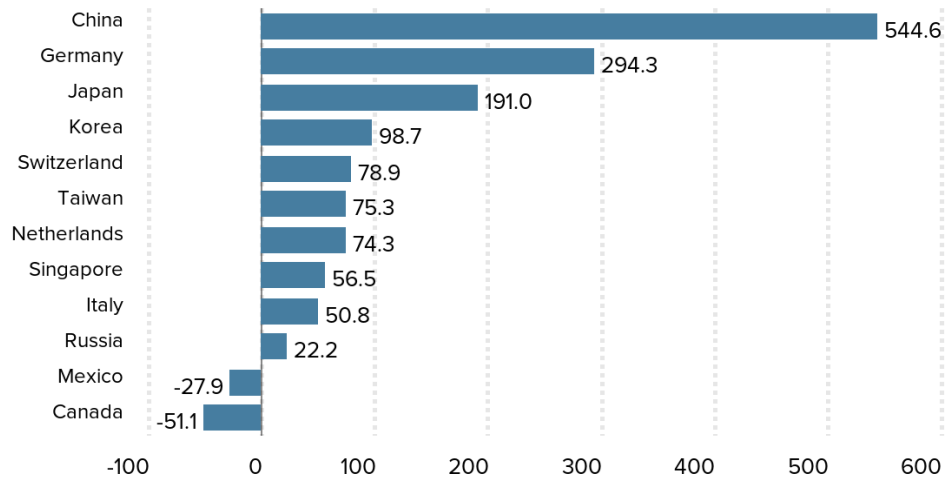
- **The trade deficit is a result of global trade imbalances.** The trade deficit is not a bilateral problem between the United States and individual countries. The U.S. trade deficit is a result of *global* trade imbalances. The causes of global trade imbalances are also well known. While dumping, subsidies, import barriers, pirating of software and technology from foreign producers, and creation of massive amounts of excess production capacity in some industries (e.g. steel, aluminum) and some countries (e.g., China, Korea, Japan) are important causes of the problem, the single most important cause is currency undervaluation. Countries with large, persistent trade surpluses have undervalued currencies. Systematically undervalued currencies are by far the most important cause of growing U.S. trade deficits.
- **Currencies can be re-aligned.** Rebalancing of major currencies, last achieved following the 1985 Plaza Accord, is the single most effective way to rebalance global trade flows. Such an agreement is needed to increase (realign) the exchange rates of the major surplus countries relative to the U.S. dollar, which is heavily overvalued. The real, trade-weighted value of the U.S. dollar has *increased* about 19% since mid-2014, alone, as shown below. Recent research has shown that a 10 percent appreciation of the U.S. dollar will increase the trade deficit by about 1.22 percent of GDP (\$226 billion in 2016). These data suggest that the trade deficit is poised to rise sharply over the next two years, which highlights the importance of addressing the overvaluation of the dollar now, before further damage is done to U.S. manufacturing and its employees, and to those of other traded goods industries.

The Trade Deficit is the Result of Global Trade Imbalances

The trade deficit is not a bilateral problem between the United States and individual countries. The U.S. trade deficit is a result of *global* trade imbalances. There are ten to twenty countries that have developed large, persistent, structural trade *surpluses* that are distorting trade flows worldwide. The top ten surplus countries are shown in **Figure A** below, along with Mexico and Canada, deficit countries that are also large U.S. trade partners. In 2016, the top ten surplus countries, led by China, also included Germany, Japan, Korea, Switzerland, Taiwan, the Netherlands, Singapore, Italy, and Russia, had a collective, global trade surplus of approximately \$1.5 trillion. (The figures reported are current account balances, the broadest measure of trade in goods, services and income.)¹ The United States' current account deficit of \$481.2 billion in 2016 accounted for less than one third of the total surplus accumulated by the top ten surplus countries shown in Figure A (Bureau of Economic Analysis 2017). Other countries have also suffered from persistent, structural trade deficits, job losses, and downward pressure on wages, including Great Britain, Brazil, Australia, Mexico and Canada. Attacking the root causes of global trade imbalances will benefit all deficit countries, and not just the United States.

Figure A

Current account balances of 10 largest surplus countries, Canada and Mexico in 2016 (billions of dollars).



Note: China's trade balance is reported in place of current account balance due to reported errors in China's broader goods and services trade flows.

Source: International Monetary Fund, World Economic Outlook Database, October 2016

Economic Policy Institute

It is also important to note that Mexico is not a country that has maintained large, global trade surpluses, as shown in Figure A. In fact, it has had significant current account deficits in every year since 2000. This analysis shows why bilateral trade data are a poor guide to trade policy development. The same is true for Canada, which has a bilateral trade surplus with the United States, but a global trade deficit in 2016 (as it has for a number of years).

On the other hand, Singapore, a relatively small country, had the eighth largest trade surplus in the world in 2016, and the largest as a share of its total gross domestic product at 19.0 percent (IMF 2017). However, United States has a bilateral trade surplus with Singapore and it is not listed among the countries named in the executive order. Yet it is clear that Singapore is a significant contributor to global trade imbalances.

Measures of each country's overall trade balance with the world provide a much more accurate and effective basis for identifying global distortions in trade flows. Measures of bilateral trade flows should not be used as a basis for evaluating or formulating U.S. trade or exchange rate policies.

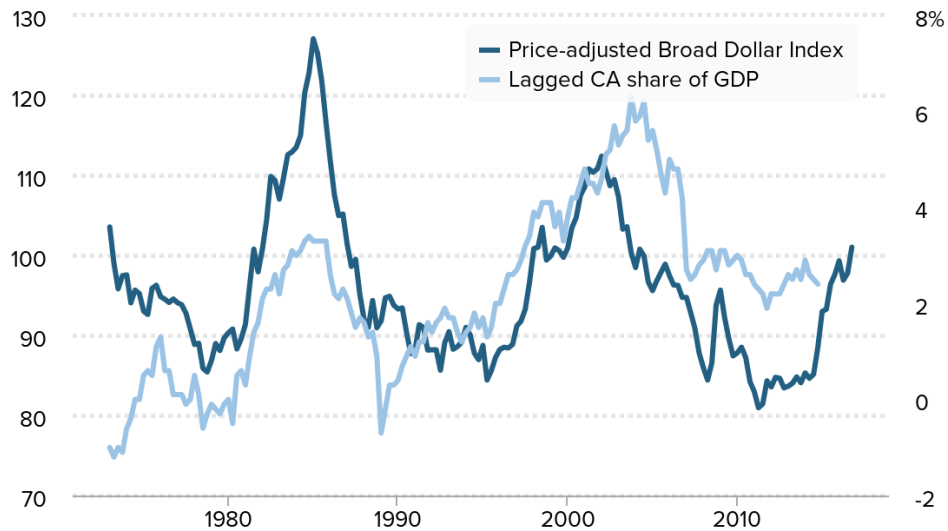
The causes of global trade imbalances are also well known (Scott 2017a). While dumping, subsidies, import barriers, pirating of software and technology from foreign producers, and creation of massive amounts of excess production capacity in some industries (e.g. steel, aluminum) and some countries (e.g., China, Korea, Japan) are an important cause of the

problem, the single most important cause is currency undervaluation. Countries with large, persistent trade surpluses have undervalued currencies. Systematically undervalued currencies are by far the most important cause of growing U.S. trade deficits. Rebalancing of major currencies, last achieved following the 1985 Plaza Accord (Investopedia 2017), is the single most effective way to rebalance global trade flows (Scott 2009). Such an agreement is needed to increase (realign) the exchange rates of the major surplus countries shown in Figure A, relative to the U.S. dollar, which is heavily overvalued.

There is a strong correlation between the value of the U.S. dollar and the U.S. current account trade deficit, as shown in Figure B. The chart shows the real, trade-weighted value of the dollar on the left axis, and the size of the U.S. trade deficit (lagged two years) on the right axis, as a share of U.S. GDP.² The U.S. dollar has increased about 19% since mid-2014, as shown in Figure B. The effects of this appreciation are not yet known (since the lagged values for the trade data for the past two years won't be known for another year or two), but Cline (2016) found that a 10 percent appreciation of the U.S. dollar would increase the U.S. trade deficit by about 1.22 percent of GDP (\$227 billion in 2016).

Figure B

Real broad dollar index and US current account deficit as a share of GDP (lagged 2 years), 1973 –2016



Source: Bureau of Economic Analysis (BEA) and the Federal Reserve.

Economic Policy Institute

These data suggest that the trade deficit is poised to rise significantly over the next two years,³ which highlights the importance of addressing the overvaluation of the dollar now, before further damage is done to U.S. manufacturing and its employees, and to those of other traded goods industries.

Endnotes

1. Data on goods trade are reported for China due to problems with Chinese data collection (Setser 2016).
2. Economic research has shown the U.S. trade deficit responds to changes in the value of the dollar with a lag of about two to three years.
3. Cline (2016) identified a two year lag in the relationship between trade flows and changes in the exchange rate.

References

Brun, Lukas. 2016. *Overcapacity in Steel: China's Role in a Global Problem*. Duke University Center on Globalization, Governance & Competitiveness and Alliance for American Manufacturing report.

Bureau of Economic Analysis. 2017. *International Economic Accounts: Balance of Payments (International Transactions)*.

Bureau of Labor Statistics. 2017. *Current Employment Statistics – CES (National)*.

Cline, William R. 2016. *Estimates of Fundamental Equilibrium Exchange Rates, November 2016*. Peterson Institute for International Economics. Policy Brief 16-22.

Gagnon, Joseph E. We Know What Causes Trade Deficits. *Trade & Investment Policy Watch*. (Peterson Institute for International Economics blog), April 7.

Haley, Usha C.V. 2008. *Shedding Light on Energy Subsidies in China: An Analysis of China's Steel Industry from 2000–2007*. Alliance for American Manufacturing report.

Haley, Usha C.V. 2009. *Through China's Looking Glass: Subsidies to the Chinese Glass Industry from 2004–08*. Economic Policy Institute, Briefing Paper #242.

Haley, Usha C.V. 2012. *Putting the Pedal to the Metal: Subsidies to China's Auto-Parts Industry from 2001 to 2011*. Economic Policy Institute, Briefing Paper #316.

International Monetary Fund. 2017. *World Economic and Financial Surveys: World Economic Outlook Database*.

Investopedia. 2017. *Plaza Accord*.

Scott, Robert E. 2009. *Re-Balancing U.S. Trade and Capital Accounts*. Economic Policy Institute, Working Paper #286.

Scott, Robert E. 2014. *Stop Currency Manipulation and Create Millions of Jobs: With Gains across States and Congressional Districts*. Economic Policy Institute, Briefing Paper #372.

Scott, Robert E. 2015. *Exchange rate policies, not high wages, are why U.S. lags China and Germany in export performance*. Economic Policy Institute, Briefing Paper #412.

Scott, Robert E. 2016. *U.S. Korea trade deal resulted in growing trade deficits and more than 95,000 lost U.S. jobs*. *Working Economics* (Economic Policy Institute blog), May 5.

Scott, Robert E. 2017a. *Growth in U.S.—China trade deficit between 2001 and 2015 cost 3.4 million jobs: Here’s how to rebalance trade and rebuild American manufacturing.* Economic Policy Institute, Report.

Scott, Robert E. 2017b. *Trump’s Plan for Trade: The last thing we need is more trade deals.* *Working Economics* (Economic Policy Institute blog), February 28.

Scott, Robert E., and Elizabeth Glass. 2016. *Trans-Pacific Partnership, Currency Manipulation, Trade, and Jobs: U.S. Trade Deficit with the TPP Countries Cost 2 Million Jobs in 2015, with Job Losses in Every State.* Economic Policy Institute, Briefing Paper #420.

Setser, Brad. 2016. “China’s Tourism Puzzle Has Gone Mainstream.” *Follow the Money* (Council on Foreign Relations blog), September 22.

U.S.—China Economic and Security Review Commission (U.S.—China ESRC). 2016. *2016 Annual Report to Congress.* Washington, D.C.: U.S.—China Economic and Security Review Commission. November 16.