In many eyes, President-elect Trump is a loose cannon. He says things that upset people the world over. Many of them perhaps should not be taken too seriously – after all, he is a showman. But it would be a mistake to dismiss his rhetoric on trade. There, he is in deadly earnest – and it does not bode well either for America or for the world.

Trump’s trade agenda was set in Peter Navarro & Wilbur Ross’s paper (pdf) of September 2016. Peter Navarro’s most famous work is the documentary “Death By China” which essentially blames China for all America’s woes. Wilbur Ross is a businessman who made a fortune from buying up and restructuring manufacturing businesses, many of them protected by George Bush’s trade tariffs. Both of them are unashamedly protectionist, labelling countries running large trade surpluses as “cheaters” and “manipulators” and demanding that the rules of international trade be changed to benefit America at their expense. Both of them have been appointed to top trade jobs by Donald Trump.

Navarro & Ross identify three causes for what they describe as
“America’s economic malaise”. Two of them – high taxation and over-regulation – are long-standing complaints by America’s right-wing business community. But the third is new. Navarro & Ross explicitly blame America’s trade deficit for poor GDP growth. And they claim that the trade deficit is entirely due to unfair practices by America’s principal trading partners:

Trump views America’s economic malaise as a long-term structural problem inexorably linked not just to high taxation and over-regulation but also to the drag of trade deficits on real GDP growth. Trade policy factors identified by the Trump campaign that have created this structural problem include: (1) currency manipulation, (2) the equally widespread use of mercantilist trade practices by key US trading partners, and (3) poorly negotiated trade deals that have insured the US has not shared equally in the “gains from trade” promised by textbook economic theory.

They name China and Germany as currency manipulators, China as the biggest “trade cheater” (i.e. mercantilist), and Canada, Mexico and South Korea as benefiting from unfair trade deals.

Many people have pointed out gross economic errors in Navarro & Ross’s analysis. At Vox, Matt Yglesias explains how imports contribute to exports: imposing high tariffs on imports simply raises business costs, reducing business profits and threatening people’s jobs. The economist Greg Mankiw notes that they fail even to mention the effect on the capital account (foreign investment in America) of closing a current account deficit. Paul Krugman describes their discussion of VAT as “utterly uninformed”. And Larry Summers says Trump’s global economic plan is based on a “misunderstanding of how the global economy works”.

I’m with Larry Summers on this. Navarro & Ross have failed to understand the nature of the US’s relationship with the rest of the world. And they have therefore disastrously misinterpreted the cause of its trade deficit. There may well be currency manipulation, mercantilism and skewed trade deals.
But these are not the principal cause. No, the main reason for the US’s trade deficit is the US dollar.

The US dollar is the world’s premier currency for international trade and investment. More trade is done in U.S. dollars than any other currency. More trade finance is issued in U.S. dollars than in any other currency. More business investment is financed in U.S. dollars than in any other currency. Global markets price oil, metals and commodities in dollars. Even currencies are priced in dollars. The world relies on dollars to lubricate the flow of goods and services around the world.

The “quantity of money” equation $MV=PY$ tells us that the quantity of money in circulation should be sufficient to maintain steady output. In a closed economy, when there is too much money in relation to output, there is inflationary pressure: too little, and there is risk of deflation. But because the US dollar is so widely used in the global economy, the quantity of dollars needed to support global trade far exceeds the US’s productive capacity. This does not cause inflationary pressure, as the equation suggests. Rather, it creates a balance of payments problem.

How global demand for dollars creates a balance of payments problem for the US was first described by the economist Robert Triffin. Testifying before Congress in 1960, Triffin explained how the US’s trade deficit was essential for the global economy, but potentially disastrous for the United States:

*If the United States stopped running balance of payments deficits, the international community would lose its largest source of additions to reserves. The resulting shortage of liquidity could pull the world economy into a contractionary spiral, leading to instability.*

*If U.S. deficits continued, a steady stream of dollars would continue to fuel world economic growth. However, excessive U.S. deficits (dollar glut) would*
erode confidence in the value of the U.S. dollar. Without confidence in the dollar, it would no longer be accepted as the world’s reserve currency. The fixed exchange rate system could break down, leading to instability.

Triffin’s Dilemma, as this came to be known, played out throughout the 1960s and eventually led to the Nixon Shock in 1971, when President Nixon suspended the convertibility of the dollar to gold. From that time on, the US has been able to run persistent trade and, often, fiscal deficits without risking a damaging run on the currency. Indeed, such is the global demand for US dollars that until the era of central bank intervention and QE, the US was able to fund its growing pile of government debt at lower interest rates than any other country. The US Treasury is the world’s premier savings product, and the interest rate on US T-bills is regarded as the nearest we can get to a risk-free rate in the real world.

The US’s ability to obtain very large amounts of debt at very low interest rates is known as the US’s “exorbitant privilege”. But it could also be regarded as an “exorbitant burden”. The role of moneylender to the world means the US must be a net exporter of dollars. There are two ways of exporting dollars: one is to lend them, and the other is to buy goods and services. The US does both. Its banks -including the Federal Reserve banks – lend dollars to the world, and its citizens buy imported goods and services from the world.

As this chart shows, the era of globalisation has been marked by a rapidly increasing US trade deficit.
Navarro & Ross wrongly blame this on the trade practices of other countries, failing to recognise its true origin in the US’s responsibility for maintaining global dollar liquidity as global trade increased during this period. And consequently, they have come up with a policy prescription which, by closing the trade deficit, would cause a crisis of dollar liquidity, potentially leading – as Triffin warned over half a century ago – to a global contractionary spiral. We have a name for such a spiral. It is called a Depression.

I suppose Trump and his team of voodoo economists would say that they don’t care if the rest of the world goes into a Depression, as long as America is ok. But there is no way that America could be insulated from the effects of such a severe global monetary contraction. To show this, we have to look at how such a monetary contraction would play out.

In the first stage, banks lend less to the world. In fact, this has been happening ever since the financial crisis of 2008. Tighter capital requirements mean banks are effectively penalised for lending to higher risks: this is causing a credit crunch for businesses (pdf), especially small and medium size enterprises and particularly in developing countries. In part due to banks’ reluctance to provide trade finance, and in part due to poor demand in developed
countries, global trade volume has declined significantly since 2008, though a rising dollar has helped to maintain global trade value:

(Chart from David Stockman)

The US’s trade deficit has already reduced significantly, which indicates that there are fewer dollars in circulation than there used to be.

For much of the period since the 2008 financial crisis, the Federal Reserve’s QE programme maintained or even increased global dollar liquidity. But that is now ended, and the Federal Reserve is progressively raising interest rates. This has the effect of tightening global monetary conditions. In response to this, the dollar’s exchange rate is rising.

A rising dollar exchange rate makes America’s exports less competitive and encourages imports. This is entirely the opposite of what Navarro & Ross want: they want to reduce imports and increase exports. So, to the next stage of the process. To counteract the effect of the rising dollar, businesses are penalised for importing, and citizens pay
higher prices for imported goods because of those penalties. What effect does this have?

Clearly, America’s imports would fall, reducing the trade deficit. This is of course exactly what Navarro & Ross want. But the flip side of reducing the trade deficit is global dollar liquidity shortage. This would reveal itself as a sharply rising dollar exchange rate, especially in relation to the currencies of developing countries. If the Federal Reserve did nothing to counteract it, then the effect of the Trump team’s protectionist measures would be to put upwards pressure on the dollar, impeding America’s exports.

The worsening global dollar liquidity shortage would force China and other holders of US Treasuries to sell down their holdings. Such sales would be likely to raise yields on USTs, to which the Fed would most likely respond by raising the Fed Funds rate. So the tightening effect of the rising dollar could be compounded by faster monetary tightening from the Fed.

Closing the trade deficit when the dollar is rising would require progressively harsher trade controls. Larger penalties for importers and price rises for citizens. And because restricting imports raises costs for businesses, we would start to see business failures, resulting in falling GDP and rising unemployment. This is exactly the opposite of the effect they claim that closing the trade deficit would have.

Not that they would succeed in closing it, though. Other countries would inevitably respond to America’s protectionist measures by imposing tariffs on American goods and services. This, in addition to the rising dollar, would make America’s exports prohibitively expensive. So the effect of Navarro & Ross’s protectionism would be a severe contractionary spiral in global trade, with America at the epicentre. It is not hard to imagine what the effect on the American economy would be.
It is, of course, possible to close a trade deficit by initiating a severe recession. Indeed, it is probably the ONLY way of unilaterally closing a large and persistent trade deficit. Navarro & Ross’s protectionism would not improve prosperity in America. On the contrary, it would be a severe economic decline, perhaps even another Depression. And as always, the worst hit would be the working poor – the very people who voted for Mr. Trump in the hopes of a better life.

*Image from the LA Times.*

[Coppola Comment]