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Reflections on Trade: Part I

Donald Trump ran on a platform opposing free trade. Although Congressional support for free trade has been waning for some time, the general consensus among economists is that free trade makes the economy more efficient and supports global stability.

However, the steady erosion of manufacturing jobs in the U.S. and the shrinking of the middle class¹ have called the consensus view into question. It is clear that President Trump's anti-trade rhetoric resonated with voters and was one of the factors that led to his election.

Since the election, there have been a number of assertions made about trade, both positive and negative, that appear to us to be only partially true and perhaps designed to support a particular position. Trade can be negative for participants facing competition from abroad; for the overall economy, it does seem to bring more variety and lower prices.

In this multi-part report, we will offer several reflections on trade that we hope can provide some insight into how to use macroeconomics to judge the veracity of certain claims. It is our goal to present a fair reading of economic theory that will help readers make sense of what the media reports. This topic is worthy of a

¹https://www.nytimes.com/2017/04/24/business/economy/middle-class-united-states-europe-pew.html?_r=0

geopolitical report because American trade policy has been a critical element in how the U.S. manages its superpower role. In Part I, we will lay out the basic macroeconomics of trade. In Part II, we will discuss the impact of exchange rates and further examine the two models of economic development. Part III will analyze the reserve currency's effect on trade. Part IV will look at some real world examples and conclude with market ramifications.

Are imports a drag on growth?

The current administration has made the assertion that imports are a drag on growth, which comes primarily from Peter Navarro, the Director of the White House National Trade Council. Strictly speaking, it is correct. In national income accounting, imports are subtracted from GDP. The reason for subtracting imports from the calculation is to avoid double counting.

Gross domestic product (GDP) is the sum of consumption (C), investment (I), government consumption (G) and net exports (X-M), or:

$$GDP = C + I + G + (X-M)$$

One way to think about GDP is that it is the sum of all things produced inside a nation's borders. Thus, all things produced must fall into the above equation's components—in other words, everything produced is either consumed by households, represents investment for firms, consumed by the government or consumed by foreigners via exports. If imports are not subtracted, it would overstate GDP, which, to reiterate, is domestic production within a nation. Imports are not produced within a nation.

Another way to think about imports is that all imports are consumed in some fashion. They are bought by households, firms, the government or re-exported. Thus, they are already counted in the GDP equation.

Although imports do reduce GDP, they are not necessarily a measure of “loss.” A nation may import some goods that are not produced at home and thus blocking these goods doesn’t improve the wellbeing of a nation. Additionally, even if the good is produced at home, comparative advantage² may mean we are better off importing the good anyway. In some cases, imported goods allow a nation to boost overall output; importing capital goods to build productive capacity or raw materials to produce finished goods are examples of beneficial imports. At the same time, there are cases where imports do adversely affect domestic industries and jobs. However, we believe it’s better to examine this issue in a broader context. If imports were inherently bad, then the world’s most obvious autarky, North Korea, should be the most prosperous nation on earth. That would be a difficult position to defend.

Is mercantilism viable?

Mercantilism is the trade theory that suggests a nation is strengthened to the degree that it runs a trade surplus and accumulates foreign reserves, usually in the form of precious metals. This is an old theory that was disproven by David Hume in 1752 in his analysis of the price-specie flow mechanism. Essentially, Hume argued that if a nation accumulated gold by exporting more goods than it imported, the money supply would rise and cause price levels to rise. As price levels increased, foreign

² David Ricardo produced this theory of trade in 1817.

https://en.wikipedia.org/wiki/Comparative_advantage

goods would become more attractive in price and lead to a reversal of the flows. If trade barriers prevented the reversal of precious metals flows, the overall outcome would simply be inflation. A good example is colonial era Spain, which captured enormous amounts of precious metals from its colonies in the Americas. The accumulation of silver and gold reportedly bolstered the trend toward higher prices.³

Despite this analysis, politicians since the 18th century have still supported what are essentially mercantilist trade policies. Initially, the thought was that large government coffers of gold would give a nation the resources to fight wars and thus was a form of defense spending. In logic, this is known as the error of composition. This classic error is the mistaken belief that what holds for the individual is true for the entirety. There is a natural human tendency to see saving as an individual virtue and mercantilism appears to be a form of saving. If it’s an individual virtue, it “must” be a collective one as well. As Hume noted, not necessarily.

How does trade become unbalanced?⁴

Among the general public, the macroeconomics of trade are not well understood. Often, the focus is micro-based, with concerns about the attractiveness of products. In other words, why would Germans import a Buick when they have access to Mercedes Benz? Although such concerns might make sense in terms of autos, the issues are different for the entire

³ Fischer, D. H. (1996). *The Great Wave: Price Revolutions and the Rhythm of History*. Oxford, England: Oxford University Press (pp. 82-85).

⁴ The following analysis borrows heavily from Michael Pettis. See his signature work in this area: Pettis, M. (2013). *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy*. Princeton, NJ: Princeton University Press.

economy. Occasionally, an economist on television will make the statement that the U.S. trade deficit is due to a lack of saving. This is true, but it's only part of the story.

When looking at the economy from a macroeconomic view, we have to look at two perspectives, sources and uses. From the sources perspective, we bring back our formula from page one:

$$\text{GDP} = C + I + G + (X-M)$$

All things produced must fall into the above equation's components—in other words, everything produced is either consumed by households, represents investment for firms, consumed by the government or consumed by foreigners via exports. But from the uses perspective, the economy comprises consumption, saving and taxes.

$$\text{GDP} = C + S + \text{Tx}$$

C and I still reflect consumption and investment, respectively, but S is saving and Tx is taxes.

So, by equating these two together, we get the following:

$$C + S + \text{Tx} = C + I + G + (X-M)$$

Rearranging again gives us this identity:

$$S + \text{Tx} + M = I + G + X$$

Simplifying and rearranging again:

$$(M-X) = (I-S) + (G-\text{Tx})$$

This identity means that the private investment/savings balance (I-S) plus the public spending balance (G-Tx) is equal to the trade account. This is true in the same way a balance sheet is true—the numbers

will simply add up that way. ***What it doesn't tell us is the direction of causality!***

So, let's look at an example. If a nation's saving equals its investment and it runs a balanced fiscal budget, then it will run a balanced trade account. It doesn't matter what the exchange rate is or what trade policy is in place; if the private and public sector balances, there will also be balanced trade. It isn't magic, it's just a balance sheet.

Next, let's assume that taxes are cut and the government balance is "positive." If trade is going to remain balanced, the private sector must have an equally negative balance, meaning saving must rise relative to investment. If the private saving/investment balance is unchanged, a trade deficit will result.

This means that by cutting taxes and not addressing the government deficit, either private saving must rise relative to investment or imports must exceed exports, leading to a trade deficit. ***Consequently, a trade deficit, in effect, is the acquisition of foreign saving.*** This shows that a negative domestic saving imbalance will lead to a trade deficit. At the same time, a positive domestic savings balance will lead to a trade surplus.

This is why one will hear economists dismiss trade issues as a "mere" saving imbalance. As we note above, this is true. However, there is a moral dimension to saving, as *not* saving is often seen as a moral deficiency. This is where Pettis made his critical insight. In an open trading system, other nations can affect the domestic savings balances. ***In other words, that resulting trade deficit in the above example only occurs if there is an equal and opposite reaction in another nation in the form of a***

trade surplus. The opposite is also true. Trade surpluses only occur if some other nation accepts a trade deficit.

The “Japan Model”⁵ of development calls for policies that drive up household saving. This is usually done through financial repression and wage suppression. Referring to the last equation, $(M-X) = (I-S) + (G-T_x)$, assume that $S > I$. If the government doesn’t absorb the private saving through fiscal deficits, a trade surplus will result, as X must exceed M to balance the identity. This model is designed to provide cheap investment funds to build up the productive capacity of the country.

In contrast, the “American Model”⁶ of development relies on foreign investment. In this arrangement, $I > S$; assuming no change in fiscal stance, $M > X$. The trade deficit is an import of foreign saving for investment.

When a nation uses the Japan Model, there is foreign saving for the rest of the world that has appeared in the form of imports. In other words, M has to rise somewhere. In a two-world economy, the other economy now must run a trade deficit which is triggered by

⁵ We call this the Japan Model because it has been adopted by Asian nations for development.

⁶ We call this model the American Model because it is how the U.S. acquired saving during its industrial revolution, which began in earnest in 1870.

either the private saving balance or the public saving balance rising (or, of course, some combination of the two). In other words, investment must rise, saving must fall, government consumption must rise or taxes must fall in order to absorb the additional imports.

It is critically important to understand that for the Japan Model to work, the rest of the world must accept the developing nation’s exports. Without that willingness to absorb imports, the Japan Model doesn’t work.

As we noted above, determining the direction of causality is difficult. The fact that a nation runs a trade deficit may be due to its domestic policies or due to other nations’ policies and economic structures. Thus, the U.S. may have a trade deficit because we have policies that encourage consumption and investment and discourage saving. Or, it may be because we run persistent fiscal deficits. But, it may also be due to the fact that other nations have structured their economies to have trade surpluses that the U.S. is willing to absorb. For the most part, all these factors are in play.

Next week, we will analyze other issues related to trade.

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