



Deglobalisation Essay Series 3



October 2022

Reducing U.S. Trade Imbalances and Fighting Protectionism

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After World War II, the United States took the lead in establishing a liberal world trading order. It supported several rounds of tariff cuts under the auspices of the General Agreement on Tariffs and Trade (GATT). As Bhagwati (1988) documented, these cuts increased world trade and fuelled economic growth. Then between 1980 and 1985 the combination of anti-inflationary monetary policy and large budget deficits in the United States caused the real effective exchange rate to appreciate by 40%. The U.S. exporting and import-competing firms lost their price competitiveness. The country ran trade and current account deficits reaching 3% of GDP in 1985. Its steel, textile, agriculture, automobile, and capital-goods sectors suffered. The carnage facing American manufacturers caused members of Congress to introduce 99 trade bills that were overtly protectionist and 77 that were potentially protectionist (Destler, 1986).

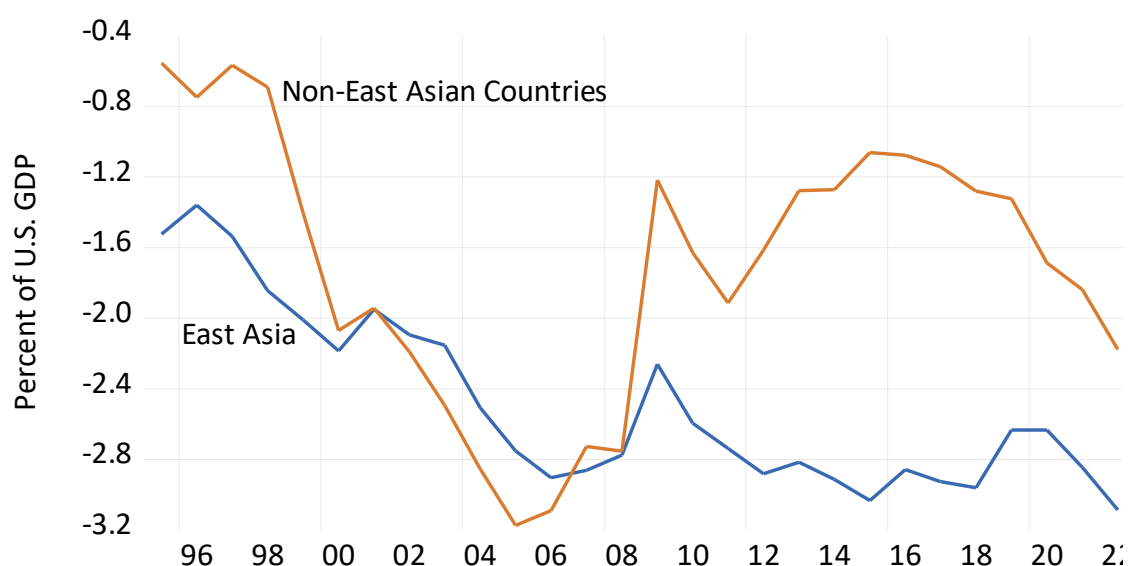
To deflect protectionist pressures, France, Germany, Japan, the United Kingdom, and the United States focused in the 1985 Plaza Accord the macroeconomic determinants of trade imbalances. The current account balance equals the difference between national saving (private saving minus the budget deficit) and investment. The United States reduced its budget deficit to increase national saving, Japan and Germany enacted stimulative policies to reduce national saving, all five countries worked together to reduce the value of the dollar, and all agreed to resist protectionist pressures. The dollar depreciated and the U.S. current account balance reached balance in 1991.

Imbalances between the United States and East Asia

Figure 1 plots U.S. trade deficits with East Asia and other countries. The figure shows that U.S. deficits with East Asia and the rest of the world increased from the late 1990s until the 2008–2009 Global Financial Crisis (GFC). Figure 1 also shows that after the 2008-2009 GFC, U.S. trade with non-East Asian countries rebalanced but its trade with East Asia did not. As Figure 2 indicates, this was especially true with China. Pierce & Schott (2016) and Acemoglu et al. (2014) documented that U.S. workers suffered “stunning” losses in manufacturing jobs from imports from China. Pierce & Schott reported that these losses were disproportionate in certain regions. This prevented workers in these regions from finding new jobs. Pierce & Schott also found that U.S. counties more exposed to competition from China suffered more “deaths of despair.” Case & Deaton (2015) similarly reported a surge in deaths from drug abuse, alcohol-related diseases, and suicides in middle-aged whites.

Figure 1

The U.S. Trade Deficit with East Asian and Non-East Asian Countries as a Percent of U.S. GDP



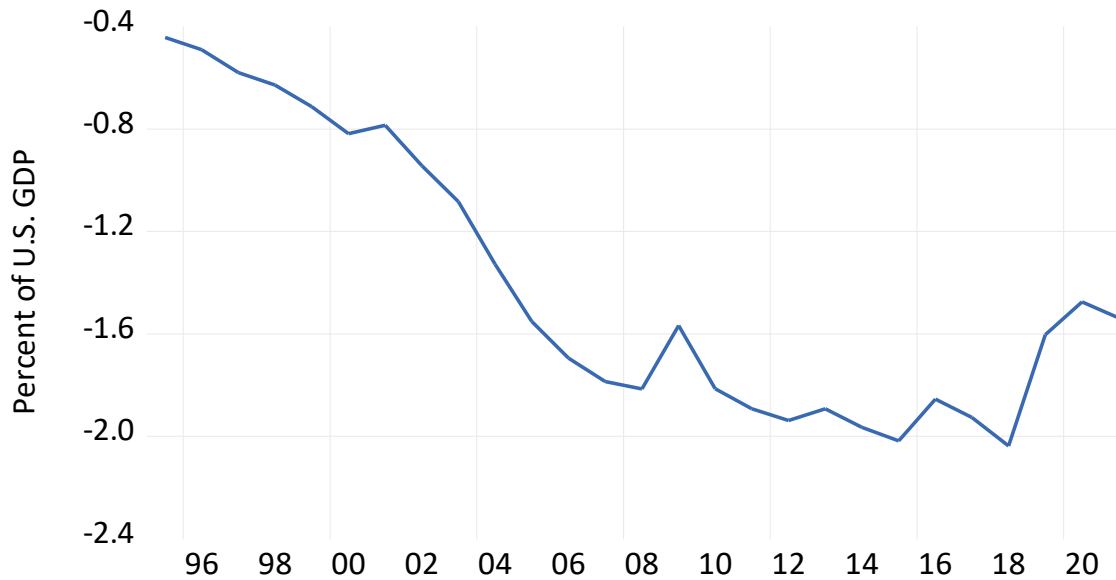
Notes. East Asia includes China, Japan, Malaysia, the Philippines, South Korea, Taiwan, Thailand, and Vietnam. Values for 2022 are forecasts using data from the first six months of 2022.

The suffering of U.S. workers stoked protectionist pressures. It led Donald Trump in 2018 to initiate a trade war against China. In June 2018, he imposed 25% tariffs on 50 billion USD of Chinese imports. China then imposed tariffs on 50 billion USD of U.S.

imports. The tariff war escalated. On average U.S. tariffs on Chinese imports rose from 3.1% to 19.3%, and Chinese tariffs on U.S. imports from 8.0% to 20.7% (Bown, 2021).

Figure 2

The U.S. Trade Deficit with China as a Percent of U.S. GDP



Note. Values for 2022 are forecasts using data from the first six months of 2022.

U.S. Trade Deficits Will Increase

The U.S. dollar broad real effective exchange rate is now at its highest level over the 28 years that the Bank for International Settlements (BIS) provides data (see Figure

Figure 3

U.S. Broad Real Effective Exchange Rate Index



Note. Values for August and September 2022 are approximations derived from the nominal exchange rate index.

3). The U.S. dollar has also appreciated 8% against the Chinese renminbi, 11% against the New Taiwan dollar, 15% against the Korean won, and 21% against the Japanese yen between the end of 2021 and the middle of September 2022. How do exchange rate changes affect trade with the United States?

The U.S. trade deficits with East Asia are driven largely by imports, since imports into the United States from the region exceeded U.S. exports to the region by almost three to one over the last 30 years.¹ Thorbecke (2022) estimated import elasticities for East Asian countries. He used data on goods imports from the U.S. Census Bureau and deflated this using import-price data for the Asian country obtained from the U.S. Bureau of Labor Statistics. The theoretical foundation for the work is the imperfect substitutes model. This holds that U.S. imports are a function of U.S. real GDP and the real exchange rate. Data on U.S. GDP are obtained from the Organisation for Economic Co-operation and Development (OECD). Data on nominal exchange rates and consumer prices in Asian countries and the United States are obtained from the Federal Reserve Bank of St. Louis FRED database. Thorbecke estimated the model using dynamic ordinary least squares and data extending from the first quarter of 1994 to the last quarter of 2019. The model also includes quarterly dummies, a time trend, dummies for the Global Financial Crisis, and four lags and two leads of the first differenced right-hand side variables.

¹ According to data from the [U.S. Census Bureau](#), U.S. exports to East Asia over the 1994Q1–2022Q2 period averaged 55,956 USD and U.S. imports from East Asia averaged 149,319 USD. East Asia includes China, Japan, Malaysia, the Philippines, South Korea, Taiwan, Thailand, and Vietnam.

Table 1*Dynamic Ordinary Least Squares Estimates of U.S. Trade Elasticities*

(1)	(2)	(3)	(4)	(5)	(6)	(7)
(2)	Economy or region	Real exchange rate elasticity	Standard error	Real GDP elasticity	Standard error	Adjusted R-squared
(3)	U.S. exports to the world	-0.52***	0.04	3.17***	0.34	0.991
(4)	U.S. imports from the world	0.50***	0.05	2.10***	0.18	0.991
(5)	U.S. imports from China	0.14	0.30	5.31***	0.29	0.971
(6)	U.S. imports from Japan	0.23	0.17	0.30*	0.17	0.623
(7)	U.S. imports from South Korea	0.22	0.16	2.57***	0.53	0.962
(8)	U.S. imports from Taiwan	-0.18	0.27	2.35***	0.63	0.923

Notes. The table presents dynamic ordinary least squares estimates of U.S. trade elasticities. In row (3), U.S. real exports to the world are regressed on the Bank for International Settlements (BIS) broad real effective exchange rate and trade weighted real GDP in 15 leading importing countries. In row (4), U.S. real imports from the world are regressed on the BIS broad real effective exchange rate and U.S. GDP. In columns (5) through (8), imports into the United States are regressed on the bilateral real exchange rate and U.S. GDP. All of the regressions include quarterly dummies, a time trend, dummies for the Global Financial Crisis, and four lags and two leads of the first-differenced right hand side variables. The data extend from 1994Q1 to 2019Q4. Heteroskedasticity and autocorrelation corrected standard errors are reported in columns (4) and (6). *** (*) denotes significance at the 1% (10%) level.

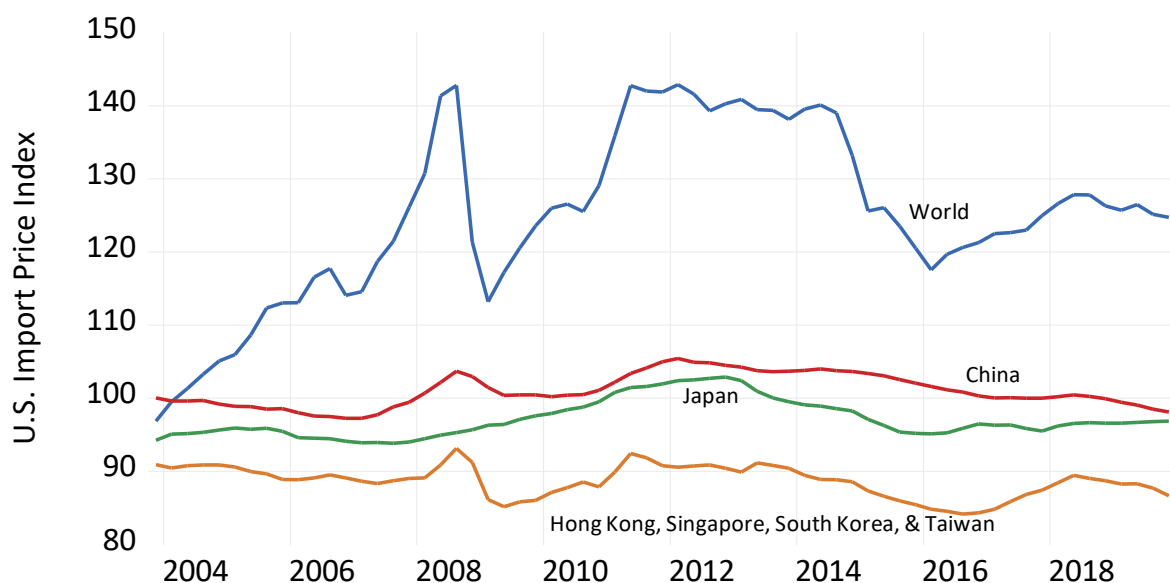
In addition, Thorbecke (2022) estimated aggregate export and import elasticities for the United States. Following the imperfect substitutes model, exports depend on the real exchange rate and real GDP in the rest of the world (ROWGDP). The real exchange rate variable for aggregate exports and imports is the BIS broad consumer price index deflated real effective exchange rate, and ROWGDP is the weighted average of GDP in 15 leading partners. The results are presented in Table 1.

The results in column (3) and rows (3) and (4) indicate that the sum of aggregate export and import elasticities are greater than one. This implies that the Marshall-Lerner condition holds and that an exchange-rate depreciation will improve the U.S. trade balance. On the other hand, the results in column (3) and rows (5) through (8) provide no evidence that exchange rates affect imports from Asia to the United States. Why would exchange rates matter for U.S. imports from other regions but not from Asia?

Figure 4 plots price indices in U.S. dollars for imports coming into the United States from the world and from China, Japan, and the East Asian newly industrialized economies (NIEs)—Hong Kong, South Korea, Singapore, and Taiwan. The figure starts in 2004, when data on import prices from China became available from the Bureau of Labor Statistics. Both the world and the East Asian economies had experienced large swings in exchange rates against the U.S. dollar over the 2004–2019 period. Exporters from other regions have allowed their dollar prices to fluctuate, but Asian exporters have not. Because exchange-rate changes in Asian

Figure 4

U.S. Import Prices for Imports from Selected Countries and Regions



Source: U.S. Bureau of Labor Statistics.

countries are not passed through to import prices, they do not impact the volume of imports.

While Table 1 indicates that exchange rates do not have an impact on U.S. imports from East Asia, it also indicates that U.S. GDP exerts a large impact. The United States' fiscal policy has been perennially expansionary and has increased its GDP. Budget deficits averaged 6.6% of GDP between 2009 and 2021. The forecasted budget deficit of 4.7% of GDP in 2022 is the same size as those that generated consternation in the 1980s. The U.S. trade deficits of 4.7% of GDP in 2021 and 5.3% of GDP in 2022 are much larger than the trade deficits of 3% of GDP in the 1980s, which led to protectionism and then the Plaza Accord.²

The appreciating U.S. real effective exchange rate will cause the U.S. trade deficit with the world to increase even more. In addition, profligate U.S. fiscal policy will cause trade deficits between the United States and East Asia to balloon. This will strengthen the forces of protectionism and deglobalization in the United States. These forces will not reduce imbalances; instead, they will make everyone poorer by worsening the allocation of resources.

² The value for 2022 is a forecast based on data from the first six months of 2022.

Policy Recommendations

Given the damage that tariffs, trade wars, and the accompanying uncertainty has wrought on the world economy, the United States and its trading partners should promote freer trade. The Plaza Accord succeeded because it focused on the macroeconomic determinants of trade imbalances. There is now an opportunity for a new Plaza Accord. The United States needs a weaker exchange rate to reduce trade imbalances. East Asian countries are confronting tumbling exchange rates. Since these economies are dependent of imports of energy and commodities and since these are denominated in U.S. dollars, weaker exchange rates relative to the dollar inflate the local currency prices of these imports and generate trade deficits. The trade deficits then further weaken their currencies. This could lead to disorderly depreciations of Asian currencies.

The United States, China, Japan, South Korea, and other countries should intervene together to weaken the U.S. dollar against Asian currencies. Experience with the Plaza Accord, joint interventions following the 2011 Japanese earthquake, and other events suggests that a coordinated foreign-exchange intervention can work. It would also be good for the world economy to see the United States and China working together. Table 1 implies that the impact of currency appreciations on East Asian exports to the United States would not be large. On the other hand, Table 1 also indicates that a weakening of the real effective exchange rate would help rebalance U.S. trade.

The new accord could also address U.S. budget deficits. From the American perspective, now is a bad time to run large budget deficits. Now only do they stoke aggregate demand and increase current account deficits, they are also in direct conflict with the Federal Reserve's goal to reduce aggregate demand and fight inflation. To offset the stimulative impact of large budget deficits that the United States ran in the 1980s, the Fed in 1981 had to allow interest rates to exceed 20%. West German Chancellor Helmut Schmidt observed at the time that real interest rates had reached their highest level since the time of Christ (New York Times, 1981). These high interest rates appreciated the dollar and increased the current account deficit. Running large budget deficits at a time when the Federal Reserve is raising interest rates will also increase debt-service costs and multiply the federal debt.

The United States should thus move towards fiscal balance (or even surplus). In the 1980s and 1990s, the Gramm-Rudman-Hollings Act mandated automatic cuts until a balanced budget was achieved. A similar approach could help the United States to curb its addiction to budget deficits. If America's trading partners stimulated their economies, this would further help to rebalance trade. Countries such as China are reluctant to stimulate their economies, but if they do, it will help to rebalance trade. East Asian economies could seek to trade an agreement to stimulate their economies for a provision in the accord stating that all the trading partners (including the United States) will resist protectionist pressures.

Coordinating a dollar depreciation, reducing U.S. budget deficits, and even stimulating economies abroad would undercut the macroeconomic forces producing large U.S. trade deficits. By deflecting the pressures that generate protectionism, this could provide the world with a new growth engine.

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October 11, 2022



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