Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

US TRADE DEFICIT AND INTERNATIONAL FINANCIAL POLICY

To: Incoming Treasury Assistant Secretary for International Finance
From: Joseph E. Gagnon
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Joseph E. Gagnon is senior fellow at the Peterson Institute for International Economics. He served at the US Federal Reserve and the US Treasury in a number of positions for over two decades.

Background: A prerequisite for success in your domain is to strengthen relationships with your colleagues in the Group of 7 (G7[1]) advanced industrial democracies, the G20[2] leading economies, the International Monetary Fund (IMF), the 37-member Organization for Economic Cooperation and Development (OECD), the World Bank, and the regional development banks. The US refusal at times over the past four years to sign G7 and G20 statements is a sign of American isolation and ineffectiveness, which weakens the ability of the United States to deal with common challenges and to coordinate better economic outcomes for Americans.

PRIORITY 1: Avert currency manipulation

The most urgent task for dollar policy is to head off worrisome signs of a resurgence of currency manipulation, the practice countries use to gain unfair trade advantages by weakening their currencies and making exports cheaper and imports more expensive. Four medium-sized economies exceeded reasonable criteria for currency manipulation in 2019,[3] with foreign exchange intervention totaling $160 billion. Intervention by these and some other countries with excessive trade surpluses has jumped considerably in recent months, a trend that must not be allowed to continue.

RECOMMENDED POLICY: Countervailing currency intervention

The best way to deter currency manipulation is to embrace the policy of countervailing currency intervention (CCI) that I proposed with C. Fred Bergsten in 2017. When a country buys US dollars to keep its own currency weak, the United States can buy an equivalent amount of that country's currency to neutralize the effect. That policy would not pose a

1 The G7 countries are: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

2 The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

3 Singapore, Switzerland, Taiwan, and Thailand. See Christopher G. Collins and Joseph E. Gagnon, "Currency manipulation remained low in 2019," July 9, 2020, RealTime Economic Issues Blog, Peterson Institute for International Economics.

threat to countries that are not intervening heavily, such as China and the G7 countries. If accompanied with a significant increase in the capacity of Treasury's Exchange Stabilization Fund, simply announcing the policy should be enough to encourage manipulators to stand down without actually requiring US intervention.

Bergsten and Gagnon (2017) proposed targeting CCI only at G20 (large) economies, but that remit should be expanded to cover medium-sized economies whose manipulation has a substantial combined effect. In order to garner international support, it will be important to adhere to economically sound and objective criteria in identifying manipulators and not to allow noneconomic considerations to play a role.[4]

ACTIONABLE TO-DO LIST:

- Immediately adopt a policy of countervailing currency intervention and increase the capacity of Treasury's Exchange Stabilization Fund to deter would-be currency manipulators.

PRIORITY 2: Address chronic trade deficits through dollar policy changes, not tariffs

Further changes to dollar policy will likely be needed to address the chronic issue of US trade deficits. President Donald Trump made reducing the US trade deficit a signature issue of his 2016 campaign. His administration used tariffs as a tool to reduce imports and bring trading partners to the negotiating table to expand access for US exports. The strategy failed completely. The trade deficit has grown steadily. The economics profession has long understood that tariffs and other trade barriers have little effect on trade balances. Exchange rate policy is the key to reducing trade imbalances. Hence, responsibility for the trade deficit is placed with the Treasury Secretary and not the US Trade Representative. A long-term goal should be to keep the trade balance within a range of –2 percent to 2 percent of GDP, preferably close to 0.

Getting surplus countries in the G7 and G20 to acknowledge the harm of currency manipulation in support of large surpluses was a genuine accomplishment of the Obama administration. However, simply forswearing intervention by all countries is not the right endpoint. There are other drivers of undesirable imbalances, mainly reflecting imperfections in private financial markets, as evidenced by so many international financial crises over the years. Countries should be free, even encouraged, to intervene in ways that limit these undesirable imbalances, as endorsed by IMF Article IV.

At 2.5 percent of GDP, the trade (current account) deficit is only moderately excessive at present and not the most urgent economic problem facing the United States. But decades of neglect have allowed the US economy to travel far down an unsustainable and ultimately dangerous path. The harm from the deficit comes through several channels:

- The US net international investment position, at –69 percent of GDP, is at a level that has proved dangerous for other countries.[5]

4 Treasury's criteria include a requirement that a currency manipulator have a bilateral trade surplus with the United States. There are no economic grounds for such a criterion.

5 Data are for 2020Q2 and exclude monetary gold, which is not a claim on foreigners. Some improvement is likely in the next few quarters as US GDP recovers and the dollar reverses the rise in early 2020.

- This debt was used to support consumption not investment and is thus a burden on future generations.
    - The burden is grossly underreported owing to measurement errors in investment income associated with foreign tax havens.
- The deficit contributes to protectionist pressures that are distorting global trade.
    - Unlike tariffs and quotas, dollar policy directly counters the forces behind an overvalued dollar, restoring balance without reducing global trade.
- The deficit has contributed to a modest but meaningful extent in the decline of manufacturing jobs that exacerbates income inequality and disproportionately harms blue collar workers.
- Expanding exports and narrowing the trade deficit helps to increase US employment when interest rates are stuck at zero without adding to record fiscal deficits.
    - Exchange rate policy cannot boost growth in all countries. It must be used only to narrow trade imbalances and not to maintain or enlarge them.

RECOMMENDED: Balanced dollar policy

If the US trade deficit should persist or grow over the next year or so, actions should be taken to return it gradually to zero. The most important action is a moderate buildup of US foreign exchange reserves toward levels seen in other reserve-issuing countries. The US Treasury should consult with foreign finance ministries and central banks on the speed and distribution of any reserve buildup. The aim would be a modest dollar depreciation that would set the trade balance on a slowly narrowing path. Surplus countries would be encouraged to boost domestic demand to allow for a gradual narrowing of their surpluses without endangering overall growth. The increase in US exports would return economic activity to potential sooner than otherwise, enabling an increase in public and private saving consistent with the narrowing trade deficit. The United States needs the IMF as a partner in endorsing moderate US action to narrow imbalances while discouraging retaliatory currency manipulation by other countries to support excessive trade surpluses.

ACTIONABLE TO-DO LIST:

- Adopt a "balanced dollar" policy: In consultation with foreign finance ministries and central banks, build up US foreign exchange reserves toward levels seen in other reserve-issuing countries. This will facilitate moderate dollar depreciation and narrow the trade deficit.

PRIORITY 3: Increase resources for the IMF, the World Bank, and regional development banks

With respect to the IMF, the World Bank, and the regional development banks, the United States should take the lead in increasing the resources available to combat future crises and support economic development. One area for immediate action is a new Pandemic Support Facility at the IMF. The United States should also cooperate in efforts to more fairly distribute voting power within the IMF and the development banks. This redistribution primarily involves reducing excessive voting shares of European countries and increasing the shares of emerging and developing economies, with little net effect on the US share.

Repairing relationships with European allies will help to smooth this adjustment. It is ultimately in everyone's interest to secure the legitimacy of the management structure of these international financial institutions.

ACTIONABLE TO-DO LIST:

- Support the Pandemic Support Facility at the IMF.
- Support a generalized increase in capital for the IMF, the World Bank, and the regional development banks.
- Cooperate in efforts to more fairly distribute voting power within the IMF and the development banks.