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ECONOMY | CAPITAL ACCOUNT

How the Tax Cut President Trump Loves Will Deepen Trade Deficits He Hates

Major tax cut, higher federal spending will push up imports, widening gap

The Congressional Budget Office is predicting the tax cut will nudge up economic growth, interest rates and the dollar, which sucks in more imports and discourages exports. PHOTO: PATRICK T. FALLON/BLOOMBERG NEWS

By Greg Ip

Updated April 18, 2018 11:33 a.m. ET

Among President Donald Trump's most deeply held economic convictions is that trade deficits are bad, yet his signature economic policy—a major tax cut—likely will deepen the trade deficits he abhors for years to come.

For now, that's more a problem of optics than economics, albeit one that may prompt Mr. Trump to dial up trade tensions with other countries.

But in the long run wider trade deficits will make Americans poorer. That's not because foreigners are stealing American jobs, as Mr. Trump often contends. Rather, it's because Americans will increasingly borrow from foreigners to sustain their standard of living. Paying them back will wipe out a sizable chunk of the tax cut's benefit.

The U.S. runs a trade deficit because it consumes more than it produces while its trading partners, collectively, do the opposite. (Another way of saying this is that the U.S. invests more than it saves, while other countries save more than they invest.) Lately, the gap has grown, to an average of $54 billion a month since October from $46 billion a month in the prior 12 months.

Some of the wider trade deficit reflects a recent falloff in foreign growth, especially Europe which the International Monetary Fund this week predicted won't last, and a surge in post-hurricane construction and replacement demand in the U.S. But some is more long lasting, in particular the huge tax cut that Mr. Trump signed into law in December and took effect on Jan. 1. Anticipation of the tax cut spurred business investment and sent stock prices up sharply, generating more spending by newly enriched shareholders. In February, Congress passed and Mr. Trump signed a budget that boosts federal spending by nearly $300 billion over the next two years.

As those two measures push up business and household spending, U.S. imports should climb. Indeed, the spillover of American fiscal stimulus is a major reason for the IMF's upbeat global outlook. For the U.S., this is a good thing: With unemployment at 4.1% the U.S. doesn't have enough spare workers to meet all the new demand so imports are a safety valve against overheating. It's one of many reasons economists don't get worked up about trade deficits: The alternative is less investment and maybe a recession.

Not so Mr. Trump who sees trade as a zero-sum game and deficits as proof the U.S. is losing. His trade agenda is geared to correcting that: renegotiating the North American and Korean free trade agreements, tariffs on steel and aluminum, and threats to impose tariffs on $150 billion worth of Chinese imports. Yet these measures would likely have at best a negligible effect on the trade gap. Tariffs will redirect some U.S. steel orders to domestic from foreign mills, but many imports have no ready American substitute. Meanwhile, some sales may be lost by American companies that have to pay more for imported inputs or are hit by retaliatory tariffs in their export markets.

Correcting the deficit with one country or in one product is often pointless because the shortfall may simply reappear elsewhere. Indeed, the shale revolution has helped slash the single biggest contributor to the deficit by boosting exports of oil and slashing imports. Yet the gap in all other commodities has grown by more than enough to offset that benefit.

Permanently reducing the U.S. trade deficit requires some combination of the U.S. saving more and other countries saving less, a tall order because saving is heavily driven by structural factors such as aging, the social safety net and the availability of credit. For many years China bolstered domestic saving by holding down its currency and controlling capital inflows, effectively restricting how much Chinese households could consume. But it hasn't lately, contrary to Mr. Trump's tweet Monday that China was playing a "devaluation game."

Permanently higher budget deficits make trade deficits worse by diminishing national saving. Larry Kudlow, Mr. Trump's chief economic adviser, in an interview with The Wall Street Journal disputed the link between the budget and trade deficits. But in a recent report economists at Goldman Sachs studied the historical record and found that all else equal, every $100 boost to the budget deficit because of policy decisions (as opposed to economic developments such as a recession) raises the trade deficit by $35.

In last week's annual budget outlook, the Congressional Budget Office predicted the tax cut will nudge up economic growth, interest rates and the dollar, which sucks in more imports and discourages exports.

The CBO agrees the tax cut will encourage Americans to work and invest more—but not by enough to match their increased consumption. It predicts the current-account deficit (which comprises goods and services trade and investment income) will be more than $100 billion larger five years from now.

The CBO thinks U.S. gross domestic product will, on average, be 0.7% larger over the next decade thanks to the tax cut, or $710 per person. But the CBO goes on to conclude that gross national product, which excludes income paid to foreigners, will be just 0.4% larger, or $470 per person. In other words, a third of the growth boost goes not to Americans but the foreigners who bought the bonds Treasury issued.

There is a real possibility that Mr. Trump, who entered office promising to save Americans from the predations of foreigners, will leave office with the U.S. more indebted to them than ever.

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Appeared in the April 19, 2018, print edition as 'Tax Cut to Widen Trade Gap That Riles Trump.'