Trade Tantrum

By Stephen Slifer *Wed, Mar 13, 2019*

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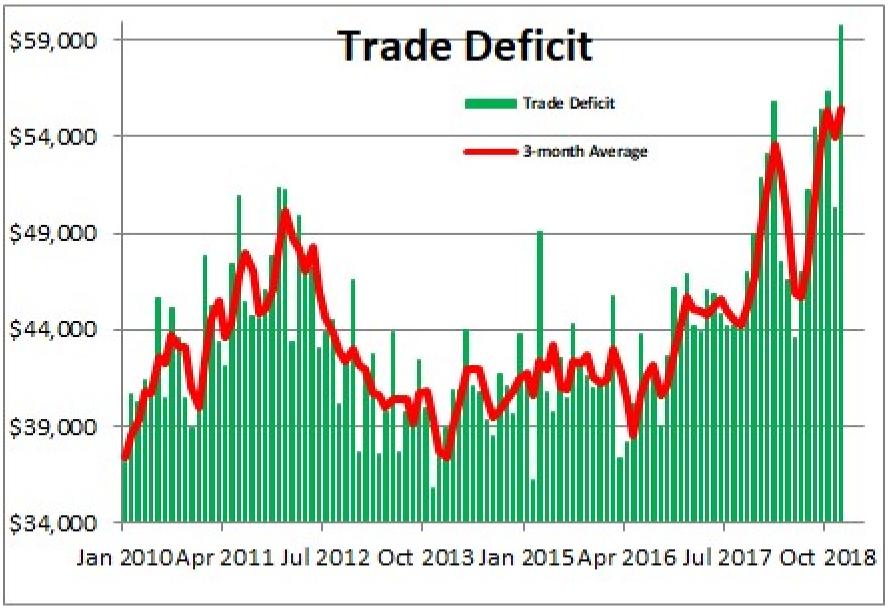
The latest piece of news to rattle the market was the revelation that the trade deficit for goods widened to a record $900 billion last year. We believe that the focus on the magnitude of the trade deficit is misplaced.

First of all, we strongly believe that trade is good. When countries trade with each other there is a wider variety of goods and services available at lower prices than there would be in the absence of trade. Both countries win. A trade deficit simply means that one country bought more goods from other countries than those countries bought from it.

Thus, trade deficits are not necessarily bad. The problem with trade is that all countries do not play by the same rules. Some countries cheat. The Chinese, for example, steal trade secrets, they do not respect copyright or patent laws, and they require foreign firms that want to do business in China to share their technology.

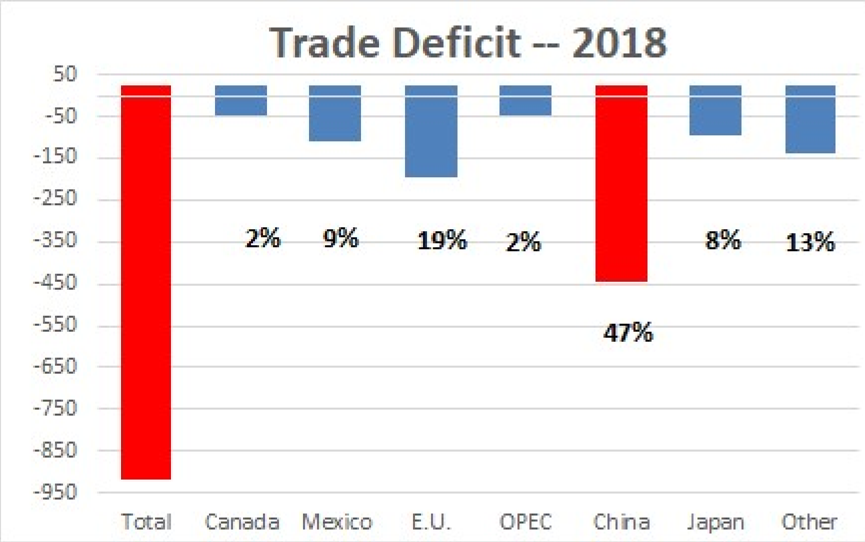
Furthermore, the yawning trade gap perhaps indicates that current trade agreements like NAFTA, as well as trade agreements with Europe and Japan, were not well negotiated and allowed other countries to take advantage of the U.S. One can make a case that the U.S. has been subsiding growth in other countries at its own expense for years. So, while the magnitude of the trade deficit is not a concern, there are fairness issues that must be addressed.



The trade deficit for goods widened to a record $900 billion in 2018. But so what? The wider deficit reflects the fact that our economy was growing faster than others and, as a result, imports rose sharply. It also means that foreigners now have $900 billion dollars to invest in the U.S. Those foreign firms could start businesses here, hire American workers, and/or invest in our stock and bond markets. What is so bad about that?

Trade is a relatively small segment of the U.S. economy and accounts for a mere 10% of GDP. Thus, the rather impressive widening of the trade gap last year subtracted a mere 0.2% from GDP growth. It is hard to conclude that the wider trade gap had any major negative impact on the U.S. economy.

Nevertheless, Trump initiated a trade war because he was concerned about the size of the trade deficit. His goal was to shrink the trade deficit and bring back jobs to the U.S. But nearly one-half of the U.S. trade deficit is with one country—China. We do not have a trade deficit problem with Canada, Mexico, Europe, Japan, or OPEC. Just China. If Trump was truly concerned about the magnitude of the trade deficit, we believe that he should have targeted those countries where the trade gap is largest.



But Trump didn't do that. He chose to impose tariffs across the board, which impacted our neighbors, friends and allies alike. Not surprisingly, the imposition of tariffs by the U.S. generated retaliation by many other countries and a trade war was underway.

While trade is a relatively small portion of the U.S. economy, it is roughly 50% elsewhere. Once the trade war began, investors scoured the globe to figure out which country might perform best. The answer they came up with was the U.S., because trade is such a small part of the U.S. economy. As a result, money flowed into the U.S. stock and bond markets and the dollar jumped 10% last year.

There are no winners in a trade war. Everybody loses. But not everybody loses equally. GDP growth in the U.S. was reduced by about 0.2% last year. But, given that trade plays a major role in everybody else's economy, their growth rates have been reduced more sharply. In the past six months, for example, the IMF has cut its forecast for growth in emerging economies this year by 0.5%. Growth rates for developed countries have also been negatively impacted.

Given that growth rates everywhere around the globe are slowing, their currencies are weakening, and their stock markets have declined, the pain of tariffs is intense. As a result, many countries are rushing to complete trade deals with the U.S. New deals have already happened with Mexico and Canada. Deals with the E.U. and the U.K. seem to be relatively close (though Brexit may delay their completion). A deal with China seems imminent.

We expect to see all of these deals completed soon simply because it is in the best interest of both sides. If that happens, we could end up with freer trade and a more level playing field that what we had initially. The process was ugly, and it may not have been the optimal way to achieve the goal but, in our view, progress was made.

If, as part of those negotiations, there is an agreement for other countries to purchase more U.S. products, the trade deficit may well shrink in the months and quarters ahead.

Sit back. Breathe. The world did not end just because the trade deficit widened to a record level last year.