Do Savings Rates Cause Trade Deficits?

Examining the Causes of the US Trade Deficit and Global Imbalances

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1. SUMMARY

Does America’s low savings rate cause trade deficits? Or do trade deficits cause a low savings rate? This working paper explains how to distinguish (a) causation from (b) mathematical interrelationships in the national income identity or equation that underlies this debate. For reasons explained below, real world changes (exogenous factors) outside the identity are the true causes. These real world changes directly impact one or more variables within the identity, transmitting through the equation by mathematical necessity. In short, national savings is related to the trade deficit in an accounting sense but does not cause it.

We further describe how policy or economic changes in trade surplus countries are transmitted to deficit countries. Becoming fluent in identifying true causation and the mechanisms of transmission is important for government officials to select US policy responses that will end global imbalances and domestic stagnation.

1 Daniel Alpert (Westwood Capital), Jason Cooper, Marc Fasteau, Ian Fletcher, and John R. Hansen also made important contributions to this paper.

2. KEY POINTS

a. The notion that America’s low national savings rate causes trade deficits is mathematically attractive but misleading. National “investment”, “consumption”, “savings”, “net trade” and “gross domestic product” are variables within national income identities. Stated another way, they are “endogenous variables”, variables internal to the equations. As endogenous variables they must mathematically interrelate because the equations must balance. While they can help identify how real world changes first impact and then transmit through the equation, they do not “cause” each other.

b. True causes are real world changes called “exogenous factors”, those outside the national income identity or equation. Examples are changes in exchange rates, interest rates, inflation, prices, taxation levels and labor supply. They cause changes in one or more endogenous factors which are then mathematically reflected by changing other terms of the identity.

c. National savings include household, business and government savings. The cultural propensity of a country’s citizens to save or spend has surprisingly little impact on
“household savings”. Wages, prices, interest rates, and exchange rates are, instead, prominent causes of the levels or significant changes in a nation's total savings rate. Fiscal deficits, which impact “government savings”, are surprisingly uncorrelated with net trade.

d. National income identities can be helpful to show how a policy change first impacts one endogenous factor and is then transmitted through the equation. The identities can also be helpful to show how policy changes in one country impact other countries. For example, a Chinese government decision to capitalize state-influenced enterprises at the expense of household consumption will result in higher investment, lower consumption and a trade surplus in China. The effect is transmitted, via price competitiveness, to other countries like the US in the form of a trade deficit, higher consumption and lower investment. The true or exogenous cause is the Chinese government decision, while the equation helps identify how the changes are transmitted domestically and globally.

e. Policy leaders can use these techniques for analyzing domestic and international causation and transmission to design the most effective solutions to counter harmful global imbalances. Becoming adept at doing so will help develop domestic policies that counter global oversupply and its negative impact on the US economy.

3. DISTINGUISHING CAUSES FROM MATHEMATICAL INTERRELATIONSHIPS

National savings, investment and net trade are variables within equations or formulas known as "national income identities". Because the variables are within the identity, they are “endogenous”. Equations or identities must balance in every possible interpretation because they are linked by the definition of their terms.

The basic gross domestic product equation is referred to as a national income identity. The basic way to express it is

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

Other formulations are:

\[\text{GDP} - C - G = S = I + (X - M),\]
\[\text{S} - \text{I} = X - M.\]

The "endogenous variables" within the national income identities are:

- \(\text{GDP}\) = gross domestic product
- \(C\) = household consumption expenditures / personal consumption expenditures
- \(I\) = gross private domestic investment
- \(S\) = national savings (household + government + business)
- \(G\) = government consumption and gross investment expenditures
- \(X\) = gross exports of goods and services
- \(M\) = gross imports of goods and services

While this paper focuses upon the national income identity, other accounting identities also exist. The balance of payments identity is Current Account Surplus + Capital Account Surplus = Increase in Official Reserve Account. The investment identity is Investment = Fixed investment + Inventory investment and Gross investment – Depreciation = Net investment.

Important “exogenous factors” that impact but lie outside the equations include, but are not limited to, exchange rates, interest rates, tariffs, taxes, wages, labor supply, productivity, and subsidies.

Endogenous variables must mathematically interrelate because the equations must balance by definition, but they are ultimately results of exogenous factors. Stated another way:

There are two types of variables in macroeconomic models: endogenous and exogenous. Endogenous variables are explained by the equations… Exogenous variables are not explained within the model. They are taken as given from the point of view of the model. For example, suppose you are trying to explain consumption of individuals in the United States. Consumption would be an endogenous variable - a variable you are trying to explain. One possible exogenous variable is the income tax rate. The income tax rate is set by the government, and if you are not interested in explaining government behavior, you would take the tax rate as exogenous.3

The identities are quite useful to show how economic and policy changes (exogenous or real causes) change one variable (say, consumption) and then are transmitted through the equations. As discussed below, the identities are also useful to show how one country's exchange rate, for example, transmits through the identities and impacts other countries' economies.

The confusion caused by many economists and pundits results from their failure to properly distinguish mathematical interrelationships from causation.

The term “capital account," as used here in the traditional manner, includes both the “capital account” and the “financial account” as now used by the IMF.

3The US Model Workbook, Yale University, https://fairmodel.econ.yale.edu/wrkbk/wb1.htm

A popular, but misleading, claim is that low US savings, relative to investment, causes our trade deficit. For example, Harvard professor and former Reagan administration advisor Martin Feldstein has said that the US fiscal deficit, which in-
deed reduces national savings, is the cause of the trade deficit.

If a country consumes more than it produces [thus saving little], it must import more than it exports. That’s not a rip-off; that’s arithmetic.4

This concise but misleading statement is based upon this identity: \( S - I = X - M \). If savings is less than investment, then exports are less than imports. Causation must start with national savings, they imply. But causation does not start with \( I \) or \( X \) or \( M \). And true exogenous causes are ignored, well except for the emotionally loaded claim that Americans spend too much, save too little, produce too little, and thus must import to support their gluttony. While their statement is a superficially witty way to equate mathematical relationships with causation, true or underlying causes - exogenous factors like exchange rates and foreign oversupply strategies - are omitted.

Daniel Griswold, formerly of the Cato Institute, has also focused exclusively upon the \( S - I = X - M \) identity to dissuade policy leaders from acting to reduce trade deficits.

The most important economic truth to grasp about the U.S. trade deficit is that it has virtually nothing to do with trade policy. A nation’s trade deficit is determined by the flow of investment funds into or out of the country. And those flows are determined by how much the people of a nation save and invest - two variables that are only marginally affected by trade policy.5

According to Griswold, causation starts with savings and investment and results in net trade. Transmission cannot go in the other direction. He implies that profligate spending Americans have dug their own hole and deserve the result.

Robert Scott of the Economic Policy Institute provides some further analysis providing more clarity.

Accounting identities do not, and cannot, explain the causal relationships between savings, investment, and trade flows. Do low savings rates cause trade deficits, or does causation run in the other direction? A trade deficit reduces the incomes of domestic workers, pushing many into lower income brackets. Families with lower incomes generally find it much harder to save. Therefore, increasing trade deficits can and do reduce national savings.6

Scott importantly states the interrelationships do not explain direction of causation. But by asserting that causation could run in both directions, he is still not clearly distinguishing the beginning of the causal chain, the real world causes, that impact the endogenous variables and are thereby transmitted through the equation. Scott does mention exogenous factors - low incomes for families - but does not go far enough for our purposes.

Professor Michael Pettis, a Carnegie nonresident fellow and Professor of Finance at the University of Beijing, is the author of “The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy” which focuses specifically upon how to analyze real world causes and the transmission of their effects domestically and internationally. He rebuts the savings causation argument this way:

[W]e often hear that the current account deficits of peripheral Europe and the United States have little to do with German or Chinese policies but are rather primarily the consequence of the very low savings rate in the deficit countries. It turns out that this widely repeated claim, which even has an attractive ring of old-fashioned morality about it, is nearly meaningless… . Current account deficits are by definition equal to the gap between savings and investment, but they are rarely “caused” by too little savings except as a tautology.7

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The better analysis is to begin by (1) identifying the major exogenous cause(s) (often foreign government policies, private or public capital flows or labor supply factors) then (2) determine how it impacts one or more endogenous variables. Next (3) identify how the change flows through to other variables within the identity, and (4) finally, for our global imbalance analysis purposes, determine means of transmission to the United States. Repeat this analysis for all other relevant exogenous (outside) changes. Policy makers can then design a strategy to change policy to neutralize the negative impacts on our economy resulting from domestic or foreign causes.

4. DEBUNKING THE MORALITY VS SAVINGS RATE HYPOTHESIS

The “dissavings cause trade deficits” proponents implicitly argue that no policy action is necessary or effective because US citizens simply do not save enough. We have caused our own problem. Our immoral, gotta-spend-it-now culture must become more austere.

National savings, in the context of the national income identity, is the aggregate of household, business and government savings. It is the extent to which national income exceeds private and public spending.

Household savings can, for example, go down if family earnings fall but they spend the same as before on necessities. Taxes or interest rates could go up causing consumers to spend less. Neither cause has anything to do with financial morality.

Surplus countries such as Germany and China have been deficit countries in the past… with low savings rates and trade deficits. Their cultural propensity to spend or save did not miraculously change. Instead, as shown below, policy changes in the 1990’s and 2000’s caused transfers of wealth from households to industry forcing less consumption and more production at increased scale and with very competitive prices. The result was more national savings and trade surpluses.

Government fiscal deficits (government savings), as a subset of national savings, have also been morally scolded as a cause for America’s trade deficits. Feldstein, for example, incorrectly asserted that the US fiscal deficit must balance to fix the trade deficit. Federal deficit spending, a massive and continuing act of dissaving, is the culprit. Control that spending and you will control trade deficits.

This “twin deficits” hypothesis asserts a direct and overwhelming link between the current account balance and the government budget balance. The hypothesis has superficial logic because government savings, as a subpart of national savings, is directly related to the national income identity. Empirically, however, there is little relationship as the graph below shows.

In the late 1990s and the early 2000s, the fiscal deficit clearly declined significantly while trade deficits rose. And during and after the 2008 recession, the fiscal deficit skyrocketed yet our trade deficit fell. The lack of an empirical connection between fiscal and current account deficits means that other exogenous factors are more important causes. Fiscal deficits could increase, for example, through

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[Figure 1: Twin Deficits? Fiscal (fed, state, local) vs Current Account]

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large infrastructure spending that increases employment and increases productivity which, in turn, would increase household income (thus household savings) and business competitiveness. In that scenario the direct impact of the fiscal deficit on the identity is overwhelmed.

Former Federal Reserve Chairman Ben Bernanke noted in 2005 that the evidence does not support the proposition that fiscal deficits cause trade deficits.

[T]he so-called twin-deficits hypothesis, that government budget deficits cause current account deficits, does not account for the fact that the U.S. external deficit expanded by about $300 billion between 1996 and 2000, a period during which the federal budget was in surplus and projected to remain so. Nor, for that matter, does the twin-deficits hypothesis shed any light on why a number of major countries, including Germany and Japan, continue to run large current account surpluses despite government budget deficits that are similar in size (as a share of GDP) to that of the United States. It seems unlikely, therefore, that changes in the U.S. government budget position can entirely explain the behavior of the U.S. current account over the past decade.9

While policy makers may have other reasons to reduce fiscal deficits, fixing the trade deficit is not one of them.

5. HOW OVERSUPPLY IS TRANSFERRED TO DEFICIT COUNTRIES

All countries cannot run trade surpluses. Offset ting deficits must exist elsewhere. The primary reason for a country to engineer persistent surpluses is to spur domestic employment by excessive reliance upon foreign consumers. The deficit country, however, experiences devaluation of its formerly well employed labor.

Many otherwise intelligent commentators and leaders misleadingly assert that persistent trade surpluses arise from national grit and merit of that countries’ workers and industry. Everybody should be able to achieve a surplus if they are smart and work hard! In 2010, German Chancellor Angela Merkel told the Bundestag, in response to international criticism of German surpluses that were harming Greece:

Where we are strong, we will not give up our strengths just because our exports are perhaps preferred to those of other countries. … The problem has to be solved from the Greek side, and everything has to be oriented in that direction rather than thinking of hasty help that does not achieve anything in the long run and merely weakens the euro even more.10

Merkel failed to recognize that financial instability, unemployment, and stagnation are direct results of surplus countries’ excessive reliance upon foreign consumers for growth and domestic employment—although her finance minister admitted earlier this year that the euro is too low for the German economy.

Global trade imbalance and domestic financial fragility are intimately related. When a nation runs persistently massive current account deficits to maintain global liquidity as has the United States now for decades, its central bank effectively relinquishes exchange rate flexibility to become a de facto central bank to the world.11

In an important speech in 2005, then-Federal Reserve Board chairman Ben Bernanke argued that the large and growing U.S. current account deficit is caused not by anything happening in the U.S., but by decisions taken by emerging economy nations to run very high savings rates, pursue export-led growth, and lend money to other countries, especially the U.S. He called the situation a “global savings glut.” These excessive inflows of foreign savings raise the U.S. dollar exchange rate, drive down our interest rates, and force our economy into a trade deficit.

Events outside U.S. borders—such as the financial crises that induced emerging market countries to switch from being international borrowers to international lenders—have played an important role in the evolution of the U.S. current account deficit.12


10Ambrose Evans-Pritchard, “Angela Merkel defies IMF and France as anger rises over German export surplus,” The Telegraph, March 17, 2010.


12Bernanke, supra.
Bernanke was in no doubt that the large current account deficit was bad for the U.S. economy. Foreign capital inflows and the resulting low interest rates encouraged overconsumption, lowered production, and played a role in housing bubbles and other forms of financial speculation, he argued.

The growth in export-oriented sectors such as manufacturing has been restrained by the U.S. trade imbalance… To repay foreign creditors, as it must someday, the United States will need large and healthy export industries.13

Professor Pettis more explicitly described the methods by which surplus countries transmit problems to deficit countries:

If any country takes steps to change the gap between its total domestic savings and its total domestic investment, then those steps must also affect its trade balance. Because a change in one country's trade balance must be matched with an opposite change in the trade balance of all other countries, there must also be an opposite and equal change in the gap between the total domestic savings of the rest of the world and the total domestic investment of the rest of the world.

… if Japan forces up its total savings relative to its total investment, either the total savings of the rest of the world must decline or the total investment of the rest of the world must rise. This is because under these conditions Japan’s current account surplus must rise, and so the current account deficit of the rest of the world must rise by exactly the same amount.14 (emphasis added).

A country can also experience wage suppression (intentionally as in Germany or because high volumes of new workers are entering the labor market as in Asia) and redirect household resources to investment. The result is that productivity increases faster than wages. Increased production outstrips the ability of domestic households to consume. Domestic supply exceeds demand and the country must rely upon foreign consumers to soak up the excess.

Germany was known as the “sick man of Europe” in the 1990’s. But it engineered domestic changes in the early 2000s to suppress wages, transferring resources to industry to increase production and price competitiveness. The Telegraph commented upon the price competitiveness impact in 2010:

Germany has gained some [30% to 40%] in cost advantage against Italy and Spain since the mid 1990s, and over [20%] against France, according to EU data. Germany’s current account surplus is expected to reach $190bn this year, or 6pc on GDP.15

German trade surpluses resulted from its newly engineered price competitiveness and were offset by deficits in peripheral Europe. Poor performing peripheral Europe dragged the euro lower in relation to German productivity ensuring the continuation of the German surplus. That surplus is further transmitted beyond the eurozone, to the US and other countries, as demand from within Europe faded with the euro crisis. In short, Germany exports goods and unemployment to deficit countries while the euro exchange rate cannot respond to rebalance trade.

In a recent speech, Lord Mervyn King, former Governor of the Bank of England, identified trade imbalances as a major international problem. He focused primarily on the distortions in the world economy caused by misaligned exchange rates.

The surpluses really are concentrated in four countries, the euro area, China, Japan, and Korea. Taken together, their combined current account surplus last year was $886 billion, just over 3% of their GDP. The deficits were also concentrated in four countries, the United States, United Kingdom, Canada, and Australia. Their combined deficits were $680 billion, just under 3% of their GDP. It is a striking example of the difference between the two “groups of four”: the Anglo-Saxon world, with its instinct of openness to trade and competitive financial markets, and Continental Europe and the Far East, with a more mercantilist outlook.16

Pettis asserts that the “global savings glut” is more of a global savings “shift”:

A global savings glut will not result in a sharp rise in global savings above the global investment level. It cannot. It will be driven by a forced increase in savings in one part of the global economy, the source of the glut, that must be met, as a matter of arithmetical necessity, by an accommodating shift elsewhere.

13Evans-Pritchard, supra.
15Id.
16Id at 19.
This shift will come as some combination of an increase in investment at home or abroad and a reduction in savings abroad. No other outcome is possible. Global savings gluts, in other words, do not necessarily or even often result in an increase in global savings. They more typically result in a shift in savings.\footnote{Pettis, supra at 107.}

As among capital, production and labor, the only non-mobile factor is labor. As capital surpluses and production shift out of one country and into another, they leave behind a devalued and underutilized labor force. Cheaper goods are received as partial “compensation.” If the effects of reduced wages and employment levels continue, average living standards across the entire economy are reduced, as in Greece, or stagnate, as in the US. Eventually one might expect the gap to close. But because the emerging world oversupply of labor is enormous relative to global demand for its production, and because exchange rates are failing to adjust, such an eventuality is in the extremely distant future.

Then French finance minister Christine Lagarde said of the German/Greece disparity in 2010:

I’m not sure it is a sustainable model for the long term and for the whole of the group. \textbf{Clearly we need better convergence}, While we need to make an effort, it takes two to tango.\footnote{Evans-Prichard, supra.}

Germany’s surplus has only increased since 2010 causing the Euro-project to become much more unstable. We describe the German methods below in more detail.

\section*{6. EXAMPLES OF SURPLUS COUNTRY ADVANTAGES AND TACTICS}

Export-oriented or investment-oriented countries can utilize policies to reduce consumption, increase production and export at very competitive prices. Their exchange rates are persistently undervalued… disconnected from a trade balancing equilibrium price. In the case of China, wages are held down by huge pools of unemployed labor now entering their modern job markets. They export oversupply, deflation and unemployment. The result is excessive reliance on demand from consumers in deficit countries.

\subsection*{6.1. CHINA}

The Brazilian investment-driven miracle in the 1960’s and 1970’s taxed households heavily to subsidize industrial production and export. That model was not sustainable and was followed by Brazil’s Lost Decade in the 1980’s. The Asian growth model was pioneered by Japan using different mechanisms to supercharge production, suppress consumption and achieve export oriented growth. China improved upon Japan’s growth strategies as described by Pettis, whom we quote liberally here:

The Asian or Japanese variety relies on less explicit taxation mechanisms to accomplish the same purpose of subsidizing investment. Rather than confiscating household wealth through high income taxes… three much more indirect mechanisms are used for the same effect.

\textbf{First, wage growth is constrained} to well below the growth in worker productivity. In China, worker productivity has grown much faster than wages. … One reason… may have to do with the huge pool of surplus labor in the countryside available to compete for jobs and so keep wages low. … workers are not able to organize except in government sponsored unions…. , The important thing to remember from the growth model perspective is that, whatever the reason, lagging wage growth in China represented a transfer of wealth from workers to employers.

And remember the impact this hidden tax has on the relationship between GDP growth and household income growth… . By effectively subsidizing employers at the expense of workers, it boosted the competitiveness of businesses, increased overall production, while constraining household income, and with it, household consumption. This forced up China’s savings rate [transferring resources to state influenced enterprises as a result].

\textbf{The second mechanism... is an undervalued exchange rate}, and most analysts acknowledged that after the massive devaluation of the renminbi in 1994 followed by soaring productivity (which increased real undervaluation of a currency), the renminbi was seriously undervalued for much of the past two decades. …

The undervaluation of the exchange rate, remember, is a kind of consumption tax imposed on all imported goods, and everyone in China who is a net importer, which includes all households… must pay this very large implicit tax.
On the other hand Chinese manufacturers in the tradable goods sector… receive the opposite "negative" tax, or subsidy, in the form of lower domestic costs relative to higher foreign prices for their goods. …

But by subsidizing Chinese exporters, thus increasing their competitive strengths relative to foreign competitors, the undervaluation of the renminbi boosts domestic production. An undervalued exchange rate is simply another powerful mechanism for increasing the gap between what a country produces and what it consumes…. 

The third mechanism for creating the domestic imbalances, and probably by far the most powerful, … is financial repression. The Chinese financial system is… severely repressed. Almost all household savings in China are in the form of bank deposits, and the banks are controlled by the monetary authorities who determine the direction of credit, socialize the risks, and set interest rates.

[Because the People’s Bank of China sets rates] very low, it is effectively transferring a large share of resources from depositors to borrowers. … [T]he total transfer from households to state-owned enterprises, infrastructure investors, and other favored institutions amounts to anywhere from 3 percent to 8 percent of GDP annually.

[T]he minimum spread between the deposit rate and the lending rate is set very high, thereby guaranteeing the banks a large, and very safe, profit. [This additional transfer from households is] roughly equal to [another] 1 percent of GDP.19

Six hundred million Chinese are not yet participating meaningfully in the globally integrated labor force and 10 million Chinese reach the age of 18 each year. China can hold down wage rates for years into the future in part because the supply of un/underutilized labor is extraordinarily large. The country is increasing nominal consumption as the Chinese are buying more goods and services than ever before on both a gross and per capita basis. But this increase lags far behind productivity growth because of the population, exchange rate and financial repression factors described above.

Because the US has an open economy, open financial markets, and a large consumer market, we have been passively absorbing China’s exports of oversupply and under-

employment. America also allows large capital inflows from China, other countries and private capital markets, driving dollar overvaluation which keeps our producers non-competitive and devalues our labor, while increasing consumer spending. Germany, Japan, South Korea and Taiwan, with their more strategically managed economies, enjoy surpluses with China.

6.2. GERMANY

After a decade of trade deficits during which it was known as the "sick man of Europe", Germany has been a persistent surplus country since 2002. Its 2016 current account surplus was a problematic 8.6% as a percent of GDP. Germany responded to its 1990's slump with a set of policies including the Hartz reforms that benefitted production by holding down wages.20 Price competitiveness improved allowing increased exports. Even as it held down domestic wages (and thus household consumption), German banks, flush with cash, exported that capital in a comprehensive program of direct loans and vendor financing to spur other eurozone countries to purchase even more German products. This increased peripheral European consumption but not production. On the other hand, German production continued to increase faster than consumption so surpluses worsened.

In addition, Germany taxes consumption at a 19% rate. Consumption taxes reduce consumption and relieve the business burden of financing government functions, health care and pension programs. The reduced costs allow greater price competitiveness in relation to US companies which pay income taxes, payroll taxes (funding pension programs and health care) and employee health insurance.

Because Germany’s high surpluses, savings growth and employment growth had to be offset elsewhere, southern Europe increasingly experienced trade deficits, low savings, low growth and low employment levels. The economic distress caused by the German-policy-induced crisis in other eurozone countries perversely holds down the value of the euro. Germany is largely exonerated from being accused of devaluing a currency it does not control. As peripheral Europe’s demand declined in relative terms, extra-European imbalances grow.

7. SOLUTIONS TO REBALANCE TRADE AND CAPITAL FLOWS

The US should first reject the false argument that our low savings rate or fiscal deficits cause our own trade deficits.

We also need to reject the view that free trade agreements will fix our trade performance. They will not because the causes of other country surpluses are so deeply embedded in their domestic policies (exchange rate misalignment and manipulation, wage suppression, a need to continually increase employment, financial repression, taxation differences) that trade agreements are ill equipped to counter them.

The US strategy should focus upon utilizing our own domestic laws and policies to stop absorbing surplus countries’ oversupply. Germany, Japan and South Korea, for example, do not import China’s surpluses and neither should the US. What policy changes would accomplish this?

7.1. FIXING EXCHANGE RATES AND EXCESSIVE CAPITAL INFLOWS

In an upcoming report, CPA will show the extent of dollar overvaluation and surplus country undervaluation. We recalibrate the FEER (Fundamental Equilibrium Exchange Rate) model used by the IMF and the Peterson Institute to target a trade balancing equilibrium exchange rate for the major economies. The results are shown in the Figure 2 and will be further explained in the upcoming paper.
Misalignment was largely caused by foreign central bank intervention between 2004 and 2014 but is increasingly driven by private capital flows and the perceived threat of surplus country intervention. The misalignment shown in Figure 2 is also highly correlated with surplus and deficit country status. The US can and should implement unilateral policies that address persistent misalignment.

First, we should strategically reduce capital flows into the US that drive the dollar’s value away from a trade balancing equilibrium price. Unless this problem is dealt with directly, other strategies to address the trade deficit risk failure.

Professor Pettis endorsed the concept, stating:

It is actually in the best interest of the United States… that the US government place restrictions on the ability of foreign countries to hold US dollar reserves. This will both benefit the American economy and stabilize the global environment. 21

A Market Access Charge or MAC, a modern capital flow management tool consistent with international rules, should be implemented. The MAC is a mechanism to drive down the dollar’s value gradually and automatically by charging foreign investors a variable fee when they buy dollar denominated assets. The Fed Funds rate and the MAC are both designed to moderate the demand and supply of capital. The Fed Funds rate affects capital circulating within the United States, while the MAC would provide its long-missing counterpart, a tool needed to moderate the demand and supply of foreign-source capital.

The MAC was developed by John R. Hansen, formerly of the World Bank. It has been endorsed by the Coalition for a Prosperous America and supported by senior staff at the Peterson Institute for International Economics and the Economic Policy Institute. It is also fully consistent with the rules laid down by the IMF in 2012 when it endorsed modern capital flow management tools after decades of rejecting old-style capital controls. 22

Second, the US should engage in countervailing currency intervention (CCI) when other countries intervene in the foreign exchange markets to drive the dollar up and drive their home currency values down. The existence of a ready-to-implement counter intervention policy would deter a substantial amount of manipulation. Fred Bergsten and Joseph Gagnon of the Peterson Institute have proposed CCI and CPA has endorsed it.

Third, US trade law should classify foreign currency undervaluation as a countervailable subsidy. The Department of Commerce should indicate its willingness to reconsider past decisions to the contrary.

Fourth, any new trade agreements should have strong remedies to prevent and correct currency misalignment and manipulation.

### 7.2. STRATEGIC BORDER ADJUSTABLE TAXATION

The US should strategically move to more border adjustability in its tax system.

First, a US consumption tax, such as a goods and services tax (GST), should be implemented in a revenue neutral and distribution neutral way by completely offsetting the payroll tax burden. This move would shift the tax burden from production and labor to consumption, just as other countries do.

In national income terms, productivity would increase because the cost of labor would be reduced for industry. Prices of domestic goods and services would not go up because the increased GST would be offset by the decreased payroll tax. Employment would increase, as initial CPA studies have demonstrated, increasing household income.

Because both the payroll tax and GST would be eliminated for exports, export price competitiveness would improve. Import prices would increase but households would be better off due to higher employment.

Second, a territorial business income tax called sales factor apportionment (SFA) should also be adopted. Under SFA, profits from exported products would not be subject to business income taxation, allowing them to be priced more competitively. Because the destination of sales determines the origin of income, SFA would also solve America’s eroding tax base problem by preventing profit shifting to tax havens. Profits from sales in the US would be subject to US tax regardless of where a company’s headquarters and intellectually property are located. The US fiscal deficit would shrink resulting in modest US savings rate improvement.

### 7.3. TARIFFS SHOULD BE CONSIDERED

Broadly applied tariffs, not merely sector specific tariffs, should be considered to counter the unearned advantages of trade surplus countries caused by their export oriented growth policies. Any tariff should be combined with a capital flow management policy so exchange rate changes do not neutralize its effect.

A tariff is a tax upon imported goods reducing foreign producers’ price competitiveness. It is a consumption tax that would, in national income terms, increase domestic production and price competitiveness. Because it also impacts consumption, any tariff should be designed to

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1 Pettis, supra at 16.

produce a pro-employment impact that overshadows any reduced real value of existing household income.

[T]he impact on unemployment is why countries intervene in trade. Trade intervention may reduce the real value of existing household income, but it can cause employment to rise by more than the loss to households, and so in the aggregate households are better off. When economists say that a lower dollar will hurt American households by raising consumption costs, they are only partly right.23

Strategically selective tariffs are another important trade policy tool. They should be used to impact the composition of trade as opposed to the overall balance. Selective tariffs could be applied to, for example, high value or strategic products that the US wants to produce. While the overall volume imports would be largely unaffected, the composition of imports would be shifted away from the tariffed items in favor of US production of these items. This strategy was historically common in the US and has been used by other countries as part of a broader industrial strategy.

8. CONCLUSION

For these reasons, the level of US savings and investment cannot and do not “cause” our trade deficit. The true causes are surplus country policies, misaligned exchange rates and global labor oversupply. Persistent trade surplus countries export their oversupply and unemployment to deficit countries characterized by open economies and open financial markets. Policy leaders must become adept at determining the actual causes, how they are transmitted through national income identities and how they result in imbalances. Effective policy responses can then be designed to rebalance trade and capital flows, increase US employment and restore our economic growth.

23Pettis, supra at 35.