BIPARTISAN POLICY CENTER

May 10, 2017

Mr. Patrick Kirwan
Director, Trade Promotion Coordinating Committee
International Trade Administration
U.S. Department of Commerce
1401 Constitution Avenue, NW
Washington, D.C.

RE: **DOCKET ID: ITA-2017-0003 Public Comments and Hearing Regarding Administration Report on Significant Trade Deficits**

Dear Director Kirwan,

Please accept these comments on behalf of Steve Bell, Senior Director at the Bipartisan Policy Center (BPC) in response to the International Trade Administration's notice of April 17, 2017 seeking input on the Executive Order Regarding the Omnibus Report on Significant Trade Deficits with selected partners. We hope the analysis below is helpful in advancing a fuller understanding of the complex factors and practices involved in bilateral trade deficits and what they actually reveal about our trade policies and relations, particularly as it relates our trade relationship with Mexico and Canada under the North American Free Trade Agreement (NAFTA). The analysis highlights that trade deficits are largely determined by economic forces such as changes in investment and savings and the exchange rate for the U.S. dollar, and not by specific trade policies or agreements. Misguided attempts to address trade deficits, which are often reflective of U.S. economic strength and consumption rather than dysfunctional trade relationship, through wholesale repudiation of longstanding agreements like NAFTA may, in the long-term, do more harm than good.

Common Misconceptions of Trade Deficits and The Benefits of Trade

Trade deficits and surpluses among nations have drawn praise and criticism from political economists, academics, and policymakers for centuries, dating back to famous British theorists David Hume and Adam Smith. Even 300 years ago the issues surrounding trade, including trade balances/deficits, were topics of fearsome debate. Indeed, Smith wrote, "Nothing can be more absurd than this whole doctrine of the balance of trade.[i]" The economic school of thought that Smith and others like Hume founded is now known as classical liberalism.

While seemingly dated, the logical construction of classical liberalism still underlies modern economic trade theory. Stated briefly, economic liberals contend that free trade, and open markets generally, will lead to specialization and productivity growth, as well as reduced prices for consumers and Gross Domestic Product (GDP) increases. Further, it begins to explain why policymakers should not overly rely on trade policy to affect trade deficits.

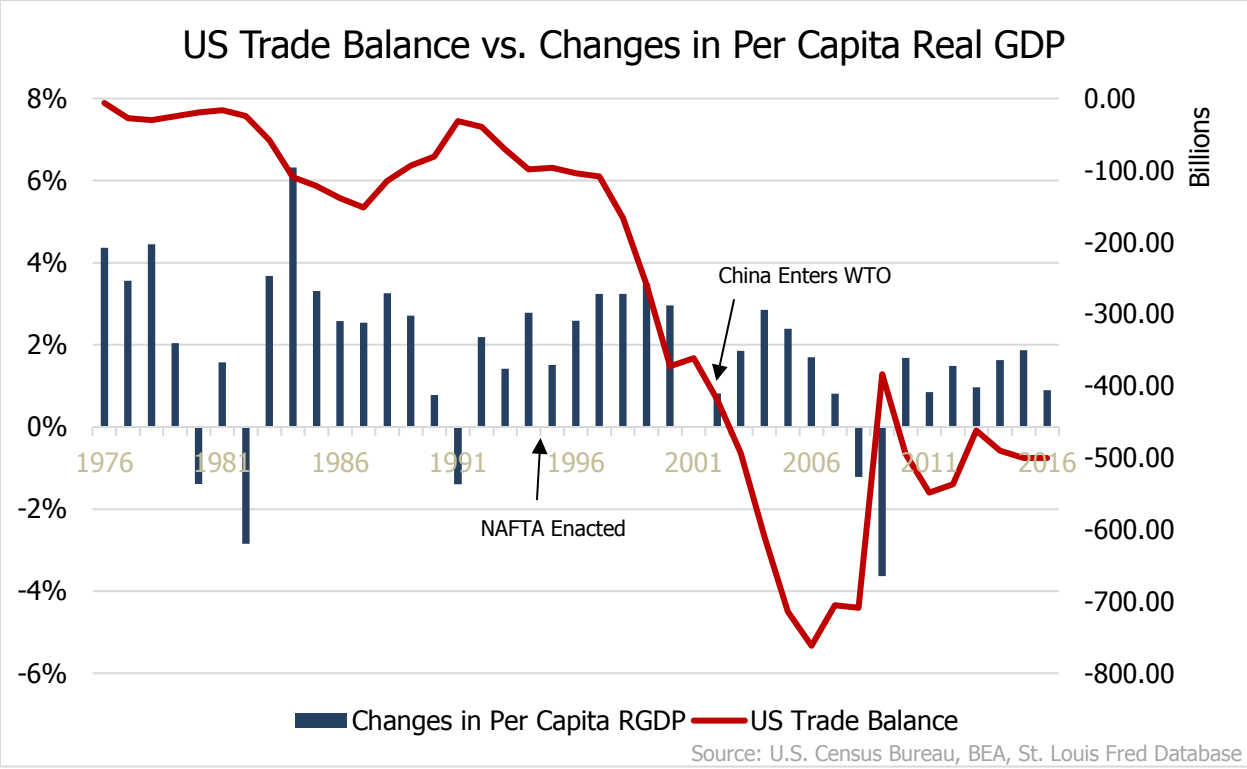
Indeed, in the modern day, economists have deduced that trade deficits are determined primarily by changes in investment and savings, not by changes in trade policy. As Gary Hufbauer and Zhiyao Lu of the Peterson Institute for International Economics summarized:

> *The aggregate US trade deficit is determined by broad macroeconomic forces, notably private savings and investment, government deficits, and the exchange rate for the dollar, rather than by trading conditions within individual countries. The United States runs an overall trade deficit with the rest of the world because the net savings of the household, business, and government sectors are negative, and the dollar is persistently overvalued in foreign exchange markets.*[ii]

The relationship between exchange rates and trade deficits has been found to be especially prominent in a world of negative interest rates in some advanced economies. In this context, the impact of the strong U.S. dollar on bi-lateral trade has been profound. For example, the Mexican peso now trades at a little more than 19 pesos to the dollar. In 2008, the peso traded at 10 pesos to the dollar.[iii] In short, the dollar now buys almost twice as much in peso terms as it did less than a decade ago. One can extrapolate the obvious effect that this would have on the trade deficit, as Mexican goods have become cheaper relative to U.S. products. The situation with Canada, the third partner in the North American Free Trade Agreement, mirrors that of U.S.-Mexican trade. The value of the U.S. dollar reached a high against the Canadian dollar in January, 2002, at 1.61:1 to a low of 0.92;1 in November, 2007.[iv] These kinds of fluctuations in currency values have the greatest and most immediate effect on how much trade flows between countries.

The latest of these fluctuations revealed that the overall American goods and services trade deficit narrowed in March of this year. Exports to Mexico and Canada rose by 15.8 per cent and 17.9 per cent, respectively.

(Figure 1) U.S. Trade Balance in Perspective, NAFTA, & China



As shown in Figure 1, the United States has run an annual deficit in goods and services with the rest of the world since 1976. During this 40-year period, America has suffered wars, recessions, riots, and many other impacts to its economy. Interest rates have dropped dramatically since the 1973 Volcker anti-inflation Federal Reserve effort and dropped even more as the Fed stabilized the economy in the wake of the Great Recession, pushing down domestic savings rates, Foreign Direct Investment, and exchange rates. Yet, for all the fluctuations in Real Gross Domestic Product (RGDP), the trade balance has varied mostly independently of these fluctuations. This independence is what we would expect from classical trade theory, with US Trade Balance and Changes in Per Capita RGDP mostly uncorrelated.[v]

However, as with all things in economics, this view is controversial; some would argue that a relationship between trade balance and per capita RGDP exists just in a more complicated and indirect way. Especially in development economics, some have argued that trade surpluses can lead to growth through an export-oriented growth strategy. This view, which was especially prevalent in the late 20th century, has been refuted to some degree by empirical findings, which tend to indicate that export-focused growth strategies are limited and in the long run might actually be detrimental.[vi]

Recent U.S. trade deals have also drawn significant controversy for their perceived effects on the trade deficit. NAFTA in particular has been at the center of controversy many times since it was signed under President Clinton, with some arguing that NAFTA has led to an increased trade deficit as well as job destruction over time. However, Monica de Boile of the Peterson Institute for International Economics warned in a recent paper that a deterioration in the NAFTA regime could "worsen the U.S.-Mexico trade deficit.[vii]" Her reasoning links back to what seem to have become basic understandings about bi-lateral trade—exchange rates, governmental and individual savings rates, productivity, and innovation.

Her article notes that "if NAFTA ultimately unravels because Mexico and the United States are unable to find common ground, the peso will likely devalue substantially." This would worsen the trade deficit with Mexico "contrary to what the US administration wants.[viii]" Her reasoning is in line with classical trade theory, as described above.

This analysis holds for Canada as well, especially considering that 75% of Canadian exports go to the United States. Recently, the falling price of oil has negatively impacted the Canadian currency, and reduced the amount of Canadian oil imports to the United States, and subsequent refined petroleum exports to Canada. It is also important to note that Canada is the #1 goods export market for the U.S. as of 2016, and that exports to Canada have increased by 165% since the signing of NAFTA. This unprecedented growth has resulted in positive U.S. trade balance with Canada.

On the other hand, trade surpluses with Mexico have been relatively rare, even before NAFTA. Indeed, the bilateral trade deficit with Mexico has dropped 15 percent since its 2007 peak. However, recent uncertainty over the future of NAFTA has caused the peso to decline drastically against the dollar, despite intervention by the Central Bank of Mexico, making cars produced in Mexico even cheaper than American-produced cars, for example, which will likely add to the trade deficit in the out-months.

Because the Canada-US Free Trade Agreement preceded NAFTA, the U.S. had already seen trade balance impacts with Canada. However, the trade deficit with Canada has decreased significantly over the last few years, with a trade surplus a possibility in 2017.

One result of an overall stronger Mexican economy specifically has been the emigration of Mexican nationals in the United States back to their native country and a reduction of net Mexican migration to the United States. This has been the case since 2010.[ix] A weakening Mexican economy, such as would be caused by a serious rift between the two countries over NAFTA, could well reverse this trend, especially if the dollar continued to rise in value against the peso.

Finally, we cannot avoid looking at alternatives that Mexico and Canada might have to its significant dependence on trade with the United States. As China expands its direct foreign investment, as it has done in Africa, it cannot help but look at opportunities in the Americas. If relations deteriorate sufficiently between the United States and Mexico, one could well see direct overtures from China to Mexico for direct investment. In addition, Mexico recently expanded its trade agreements with Brazil, the world's leading exporter of soybeans and beef, and the second largest exporter of corn, and legislation has been introduced in Mexico to diversify its corn trade. The United States cannot simply assume that Mexico will not look for other trading partners if NAFTA collapses.

Similarly, Canada has significantly expanded its free trade agreements, recently completing its agreement with the European Union (the U.S. has yet to conclude its agreement), and both Canada and Mexico remain in the Trans-Pacific Partnership, expanding their opportunities for markets outside of North America.

When one looks closely at trade in general, and NAFTA in particular, the benefits to the United States in agricultural exports, a growing Mexican economy that draws its natives back home, less expensive manufactured goods for American consumers, and enhanced political relations with its neighbors lead one to conclude that any wholesale repudiation of NAFTA would cause serious negative economic, geopolitical, and immigration consequences for the United States.

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[i] http://www.econlib.org/library/Smith/smWN14.html
[ii] https://piie.com/blogs/trade-investment-policy-watch/macroeconomic-forces-underlying-trade-deficits
[iii] http://www.x-rates.com/calculator/?from=MXN&to=USD&amount=1
[iv] Ibid
[v] BPC Calculations
[vi] http://www.sciencedirect.com/science/article/pii/0305750X84900500
[vii] https://piie.com/blogs/trade-investment-policy-watch/trumps-nafta-approach-could-worsen-us-mexico-trade-deficit
[viii] Ibid
[ix] http://www.pewresearch.org/fact-tank/2017/03/02/what-we-know-about-illegal-immigration-from-mexico/