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# Why the Trump Administration is Confused about Trade Deficits and Economic Growth

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According to the administration of President Donald Trump, a United States bilateral trade deficit with another country raises the specter of that country engaging in “unfair” trading practices. A presidential executive order signed on March 31, 2017 required officials to produce a report naming trading partner nations with which the United States had a “significant” trade deficit in goods during 2016. According to media reports, the Trump administration may react to large bilateral trade deficits by taking “necessary and lawful action,” presumably including the institution of retaliatory trade restrictions on specific countries. More broadly, Secretary of Commerce Wilbur Ross and Peter Navarro, who leads a new White House National Trade Council, have publicly stated that reducing the overall trade deficit of the United States with all its trading partners would remove the "trade deficit drag" and boost U.S. economic growth. But these views on bilateral trade deficits and the overall trade deficit reflect deep misunderstandings of trade statistics and basic economics.

## The Mismeasurement of Bilateral Trade Deficits

Bilateral deficits, such as the one the United States has with China, are calculated as the difference between the value of goods and services imported and the value of goods and services exported. Thus, the Bureau of Economic Analysis of United States Department of Commerce reports that in 2016 the value of United States imports from China was $479 billion, while U.S. exports to China were valued at $170 billion – leading to a bilateral trade deficit of $309 billion.

These bilateral trade statistics misrepresent the true value of goods sold by a one country to another due to the prevalence of integrated international production chains. Reported bilateral trade deficits do not take into account the fact that the value of goods shipped from, say, China to the United States represents both the value added by Chinese firms and also the value of inputs that the Chinese firms use from third countries, or even from the United States itself.

An example illustrates this point. Each iPhone 7 32GB imported into the United States is recorded as a $225 import from China, since this is its manufacturing cost (the price for consumers is $649, which reflects Apple’s marketing, design, and engineering costs as well as its profit margin). But out of this $225 measured as an import from China, only $5 represents work actually performed in China, almost exclusively assembly and testing. The remaining $220 represents the cost of components overwhelmingly produced outside of China, and then sent to that country for assembly. Components of the iPhones eventually assembled in China come from throughout Asia (with Korea, Japan, and Taiwan the largest suppliers), as well as from Europe and the Americas. Thus the $225 recorded import from China in actuality embodies U.S. imports from many other countries, and should not be used to measure the extent of the bilateral trade deficit between the United States and China for this product.

A more accurate measure of bilateral trade in goods would calculate the value that is added by each country rather than the gross value of the good sold by the country where final assembly and testing take place. Unfortunately, such nuanced data are not available from any standard data source like the U.S. Bureau of Economic Analysis.

What difference do inaccurate measurements make? The difference in the reported bilateral trade deficit and the trade deficit based on value added to production of goods is most profound for goods that move between the United States and China. A recent analysis by Robert Johnson of Dartmouth College calculates that in 2004 the true bilateral deficit between the United States and China was 40 percent smaller than the reported bilateral deficit when more accurate value-added measures are used. Conversely, U.S. trade deficits based on

value added with Japan, Taiwan, and Korea are larger than the reported trade deficits because those countries manufacture many of the components that are assembled in China and then imported as final goods into the United States. (It is worth noting that the difference between the gross values and value added in bilateral trade between two countries does not carry over to a country's overall trade balance since the differences between the individual trading partners' gross values and value added cancel out when the trade flows from all countries are added up.)

## Trade Deficits and Economic Growth

Members of the Trump administration propagate mistaken ideas about the impact of international trade on national economic growth. One indicator of a country's economic performance is its Gross Domestic Product which is the sum of purchases by households, investment spending by companies, spending by government, plus export sales minus import purchases. This might seem to indicate that a growing trade deficit necessarily reduces growth. However, both the trade deficit and Gross Domestic Product are outcomes of other, underlying factors.

Consider a case where the United States has a spurt of growth due to, say, an increase in infrastructure spending. This spending will raise incomes and, therefore, consumption – including consumption of imported goods. In this situation, faster growth would be associated with an increase in the trade deficit. Alternatively, the trade deficit could very well decline when there is a recession that reduces consumption of all goods, including imports – exactly what happened during the depths of the Great Recession from 2008 to 2009. Thus, the trade deficit is not an accurate indicator of the overall performance of an economy.

## Bad Economic Reasoning and Bad Trade Policy

Trump administration errors in basic economic thinking could very well produce bad effects. Efforts to reduce U.S. trade deficits by taxing imports – such as imports of finished products from China – would force American consumers to pay higher prices and could also hurt U.S. companies that depend upon imported inputs. These policies are also likely to lead to retaliatory trade policies from countries like China. Efforts to reduce overall trade deficits, in the mistaken view that these contribute to a drag on the economy, could also derail growth. It is also important to note that some of the Administration's proposed policies, such tax cuts and increased private sector investment, would likely lead to growing trade deficits, setting up conflicts among the competing tactics of an Administration that often fails to understand economic complexities.

**Read more in Michael Klein and Marc Melitz "What Do We Learn from Bilateral Trade Deficits?" and Michael Klein and Menzie Chinn "Is the Trade Deficit a Drag on Growth?" from EconoFact.org.**