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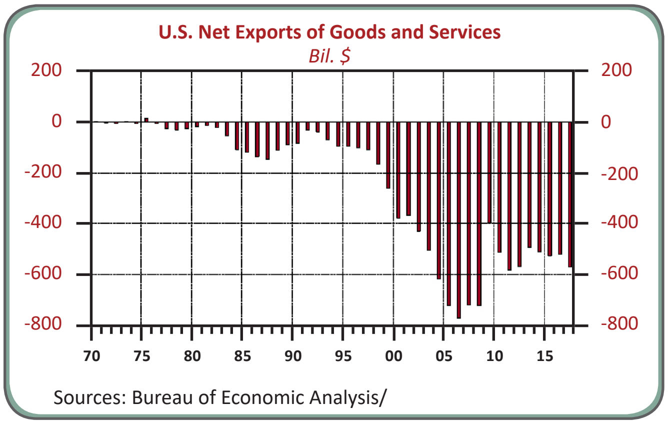
The Expected Widening in the U.S. Federal Budget Deficit Has Trade Protectionist Implications

With the recent U.S. congressional passing and presidential signing of the Tax Cuts and Jobs Act of 2017 and the Bipartisan Budget Act of 2018, the federal budget deficit is projected to increase in the next few years. According to projections by the nonpartisan Committee for a Responsible Federal Budget, the U.S. federal budget will rise from $665 billion in fiscal year (FY) 2017 to $753 billion in FY 2018 and $1.1 trillion in FY 2019. Unless these increased federal budget deficits are financed out of increased U.S domestic saving, they imply increased financing from the rest of the world. Increased lending to the U.S. from the rest of the world implies a widening U.S. trade deficit. President Trump appears to have viewed the persistent U.S. trade deficit a result of "unfair" trade practices on the part of some U.S. trading partners. (I presented a counter argument to this view in my November 17, 2017 commentary entitled "At Least We Can Be Thankful to the '11' Fair Traders".) The Trump administration has imposed import tariffs on solar panels and washing machines recently and has announced its intention to impose import tariffs on steel and aluminum because of perceived unfair trade practices on the part of trading partners. If past is prologue, a widening in U.S. trade deficits resulting from widening U.S. federal budget deficits in the next couple of years could trigger more protectionist actions by the Trump administration.

CHART 1



Let's look at some data to build a case that U.S. federal budget deficits are related to U.S. trade deficits. Plotted in Chart 1 are annual observations of U.S. net exports of goods and services from 1970 through 2017. Net exports are exports minus imports. So, if net exports are negative, it means that the value of goods and services imported by a country are is greater than the value of its exports. If net exports are negative, it means that a country is running a trade deficit. The data in Chart 1 show that the U.S. has consistently been running trade deficits from 1976 through 2017.

When a country runs a trade deficit, it means that the residents of that country are spending more on goods and services than they are producing. To see this, let's look at the identity for GDP: (1) GDP = Goods & Services Spending + (Exports – Imports). GDP is the value of goods and services produced in an economy. Goods and Services Spending is the aggregate spending by households, businesses and government entities. Imports enter the GDP identity with a negative sign in order to avoid double counting. That is, imports account for some of the Goods & Services Spending. Because GDP represents the value of goods and services produced in an economy, imports need to be subtracted from Goods & Services Spending. Because exports are not part of domestic Goods & Services Spending but are produced in the economy, exports are added to Goods & Services Spending. By rearranging the terms in identity (1), we get: (2) GDP – Goods & Services Spending = (Exports – Imports). If the term (Exports – Imports) is negative, that is, a country is running a trade deficit (net exports are negative), then GDP minus Goods & Services Spending also must be negative. So, a country that is running a trade deficit, by definition, is spending more on goods and services than it is producing. The only way a country can spend more on goods and services than it produces is to receive goods and services from other countries. Unless the residents of those countries providing goods and services to the country running a trade deficit are gifting those goods and services, the residents of the trade-deficit- running country are either incurring debt or are selling off assets to the residents of the country providing the goods and services. In sum, a country running a trade deficit is, in effect, a net borrower from the rest of the world.

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Plotted in Chart 2 are annual observations of U.S. net exports, the same as in Chart 1. But also plotted are the annual observations of net financial lending or borrowing by the combined U.S. nonfinancial sectors – households, nonfinancial business and government entities. The positive correlation between these two series for the period 1970 through 2016 is 0.81 (looks like 0.61 in Chart 2, but is 0.81). Recall, if the correlation were "perfect", its value would be 1.00. So, the data in Chart 2 are supportive of the notion that as a country runs a wider trade deficit, its net financial borrowing increases, too.

CHART 2

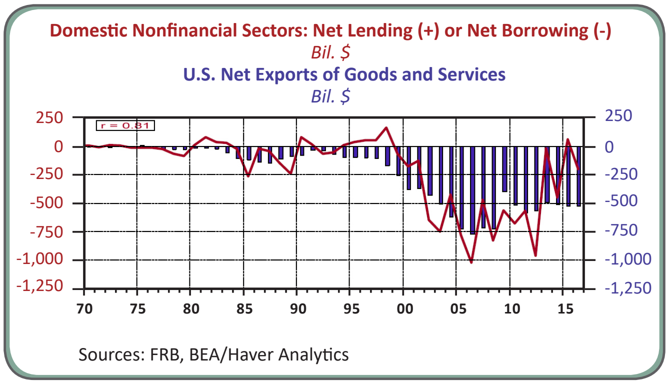
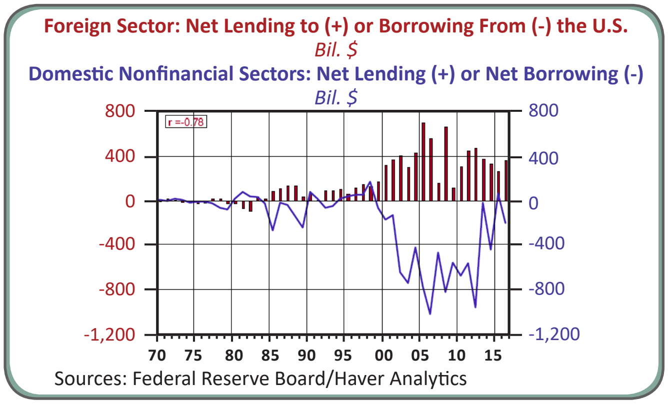


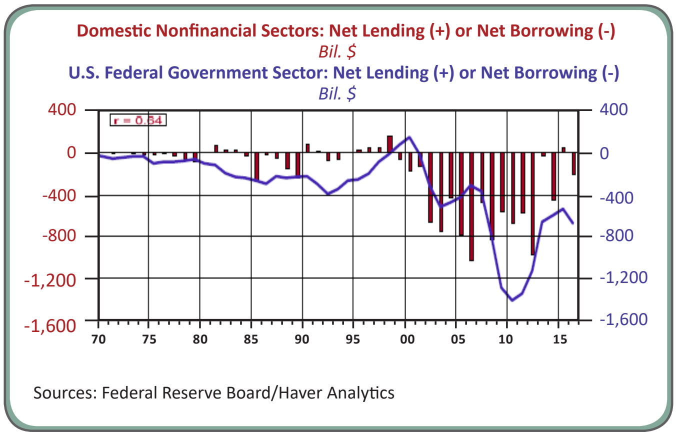
Chart 3 shows from whom most of the borrowing comes when the U.S. runs a trade deficit – the rest of the world, obviously. The negative correlation between U.S. nonfinancial sector net borrowing and the rest of the world's net lending to the U.S. is minus 0.78 for the years 1970 through 2016.

CHART 3



Okay, what does all this have to do with widening U.S. federal government budget deficits resulting in wider U.S. trade deficits? The data in Chart 4 have a bearing on this question. Plotted in Chart 4 are annual observations of net lending/net borrowing of the entire U.S. nonfinancial sector, including the federal government sector, and the net lending/net borrowing of the federal government sector by itself. The correlation between these two series is a positive 0.64. This suggests that the federal government budget deficit plays an important role as to whether the entire nonfinancial sector is in a net lending or net borrowing position. And again, if the entire nonfinancial sector is in a net borrowing position, there is a high probability that the U.S will be running a trade deficit, with the magnitude of the trade deficit positively correlated with the magnitude of the net borrowing position of the nonfinancial sector, as shown in Chart 2.

CHART 4



So, we have established that the magnitude of the U.S. trade deficit is highly correlated with the magnitude of the U.S. nonfinancial sector net borrowing position. The magnitude of the U.S. nonfinancial sector borrowing position is correlated with the magnitude of the U.S. federal government budget deficit. Nonpartisan analysts are projecting higher federal government budget deficits in the next two years. Thus, there is a high probability that the magnitude of the U.S. nonfinancial sector net borrowing position will increase in the next two years and with it, an increased magnitude in the U.S. trade deficit.

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There is a possibility that the likely widening in the federal budget deficit would not result in a widening U.S. trade deficit. That possibility rests on whether the nonfinancial sector, excluding the federal government, increases its net lending to the federal government to prevent the total nonfinancial sector, including the federal government, from slipping further into a net borrowing position. This is unlikely to happen if the federal budget deficit reaches $1 trillion+ in FY 2019. That would be a $335+ increase in budget deficit vs. FY 2017. In the three quarters ended Q3:2017, net lending by the nonfinancial sector excluding the federal government amounted to $415 billion. So, net lending by the nonfinancial sector excluding the federal government would have to increase by about 80% to prevent total nonfinancial sector net borrowing from widening and, thus, the U.S. trade deficit from widening. Possible, but not probable.

At the outset of this commentary, I noted that President Trump interprets the persistence of U.S. trade deficits as evidence of "unfair" trade practices on the part of some of our trading partners. If the federal government budget deficit widens as credible analysts project, there is a high probability that the U.S. trade deficit also will widen. This could prompt the Trump administration to adopt even more protectionist trade measures given its view of the cause of trade deficits. ■

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Paul is Legacy's Senior Economic and Investment Advisor and former Senior Vice President and Chief Economist at The Northern Trust Company. Paul works across Legacy's wealth management initiatives, consulting on investment strategies with his innovative research. Considered one of the best economic forecasters as measured by long term accuracy, Paul is a highly regarded, innovative economic researcher whose work has helped form economic policy at national and global levels.