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Tariffs increase savings in a world already drowsy with too much savings

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APRIL 12, 2018 12:00 AM
By: Guest post

In this guest post Michael Pettis, associate at the Carnegie Endowment and professor of finance at Peking University, explains the effect of tariffs in a world where investment flows are unrelated to trade . The US attempt to lower trade deficits may be worthwhile, but it has chosen the wrong way to do it.

As Washington and Beijing risk falling ever deeper into a tit-for-tat series of tariffs, it is important to understand how tariffs actually affect trade. While they can reduce trade deficits under certain conditions, they will not do so in the current global balance of payments environment, and will instead only cause global growth to weaken further.

Most of us understand tariffs in a straightforward way. In theory, by raising the prices consumers must pay for foreign goods, import tariffs cause consumers to switch their purchases from foreign producers to cheaper domestic producers. As imports of the targeted goods decline, so should total imports, bringing down the trade deficit.

The impact on associated capital flows is, accordingly, also straightforward. Capital and trade flows must always balance, and we assume that the tariff-related contraction in the trade deficit will automatically reduce net capital inflows into the country, keeping the two in balance. Although this assumption is usually unstated, it is necessary if tariffs are to reduce the deficit.

But while tariffs did indeed work this way until the 19 th Century, when capital flows consisted mostly of trade finance, they no longer do. Capital flows today are largely investment flows, unrelated to trade, but because the capital and trade accounts must still balance, if foreigners continue to invest as much into the US as before tariffs were imposed, Washington's tariffs will not reduce (https://www.bloomberg.com/view/article s/2018-01-25/protectionism-can-t-fix-trade-imbalances) the US trade deficit and could even increase it (https://www.bloomberg.com/view/articles/2017-02-08/trade-deficit-with-mexico-is-good-for-america). This iron-clad rule cannot be violated: if net capital inflows don't decline, tariffs will merely cause Americans to shift from one set of imports to another.

This doesn't mean that tariffs have no impact. Tariffs do affect trade balances, but not by changing relative costs, as is generally assumed. They do so rather by altering the domestic relationship between savings and investment. In raising the cost of imports, tariffs reduce the real value of household income relative to GDP, effectively subsidising local producers via implicit transfers from households.

As the household share of GDP declines, so does the consumption share, while its obverse, the savings share, rises. This, by the way, is also how the undervalued currencies or artificially low real interest rates that characterized China and Germany in the early 2000s work. Undervalued currencies, like tariffs, subsidize producers by implicitly taxing household consumers, while low or negative real interest rates do the same by taxing household savers.

The effect is always the same. In each case, as the household share of GDP contracts, the country's total savings share automatically expands. As domestic savings rise relative to domestic investment, a country's trade surplus rises (or its deficit declines). The change in the trade balance can only occur (https://www.bloomberg.com/view/articles/2017-05-08/actually-americans-don-t-spend-too-much-and-save-too-little) to the extent that the country's net capital flows also change, but if tariffs have any impact on the trade deficit, they do so by reducing the consumption share of GDP and forcing up savings.

While these various policies (tariffs, cheap currencies, low real interest rates) reduce each country's contribution to global consumption, they boost growth for that country anyway by increasing its claim on foreign consumption. This is why beggar-thy-neighbor trade policies are damaging to the global economy: they boost a country's growth while reducing its contribution to global demand as each country forces suffering households to subsidise its international competitivity.

This doesn't mean there is nothing Washington can do or should do to reduce the American trade deficit. Policies abroad that force up the domestic savings rate affect trade, whether or not that is the intent, but while these policies can be legitimate ways (https://carnegieendowment.org/chinafinancialmarkets/75972) to boost domestic growth, the resulting trade surpluses create destabilising deficits elsewhere.

Put differently, surpluses don't arise because surplus countries can produce goods more productively or efficiently. They arise from the need to export domestic savings caused by the low household income share of GDP. Because surplus countries direct their excess savings mainly to the US, the only economy deep, flexible and open enough to absorb them, it is the US that must inevitably run capital account surpluses and the corresponding trade deficits, which force Americans to choose (https://carnegieendowment.org/chinafinancialmarkets/67867) between higher unemployment and a rising debt burden.

This is why Washington is right to implement policies aimed at reversing the US trade deficit. If it does so with tariffs, however, the US will be no better off and the world will be worse off. Because trade imbalances are the consequence, not the cause, of capital imbalances, tariffs will not reduce the trade deficit. It is only by directly addressing excess capital inflows that the US can reduce its deficit. Meanwhile, as China and the US – and soon enough other countries – escalate their tariff wars, global demand will only weaken even further.

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