US faces twin deficit crisis

Budget deficit expected to rise to peace-time high

by Desmond Lachman in Washington

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It would be an understatement to say US President Donald Trump has failed to deliver on his campaign promise to close the US trade deficit and promote domestic manufacturing jobs. The country's trade deficit has widened steadily over the past two years, reaching a record high of almost $1tn annually.

With his administration's budget and trade policies, the deficit will probably continue widening for the remainder of his first term. This might come as a surprise to Trump. But anyone who has taken an introductory course in international economics knows the main determinant of trade deficits is not the level of a country's import tariffs, but whether the country saves enough to finance its investment. If a country reduces its savings and increases its investment level, its trade deficit will widen, as has happened for US over the past two years. A strengthening dollar makes it more difficult to export and cheaper to import. Another basic economics lesson is that with a floating exchange rate, an increase in a country's capital account surplus will necessarily be matched by a widening in its current account deficit.

There is every reason to expect that, over the next two years, the US trade deficit will exceed $1tn per year. Among the main reasons for this is the Trump administration's budget policy, which holds out the prospect of a major decline in the country's savings level. That policy includes an unfunded tax cut that the Congressional Budget Office estimates will increase public debt by $1.5tn over the next 10 years. It also includes support of a Congress-approved $300bn increase in public spending over the next two years.

As a result of Washington's expansive budget policy at this late stage in the economic cycle, analysts expect that over the next two years the US budget deficit will rise to a peace-time high of more than $1tn. This makes it probable that the US will face a twin deficit problem – an outsized budget deficit and an outsized trade deficit –previously seen in the 1980s during Ronald Reagan's presidency.

Another reason to fear the US trade deficit will widen in the year ahead is that a strengthening dollar will discourage exports and incentivise imports. Already over the past year, the dollar has appreciated by around 10%. This will probably continue in the period ahead, as US monetary policy becomes increasingly out of sync with that of its major trade partners. Expansive budget policy is forcing the Federal Reserve to keep raising interest rates to prevent economic overheating. Meanwhile, the European Central Bank and Bank of Japan are continuing to provide support to their economies. In the process, they are increasing the relative attractiveness of US financial assets.

A further factor likely to contribute to dollar strengthening is the global financial market turmoil caused in part by the uncertainty engendered by Trump's 'America first' trade policy. As often happens in times of global turmoil, investors are likely to repatriate capital to US safe havens. As a matter of arithmetic, under a floating exchange rate regime as the US capital account surplus strengthens, its external current account and trade account deficits must be expected to widen.

Judging by past behaviour, it would be too much to expect Trump will assume responsibility for the country's disappointing trade conduct under his watch. Ultimately, his economic policies risk returning the US to the debilitating twin deficit problem of the 1980s.

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