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Budget Cuts Can Trim the Trade Deficit

CAPITAL ACCOUNT

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The trade deficit has been an obsession of Donald Trump throughout his public life.

And yet as president, his policies have often been at odds with narrowing it.

Business-friendly deregulation and tax cuts boost private investment and widen the budget deficit. That pulls in imports and pushes interest rates and the dollar higher, depressing exports.

Tariffs, meanwhile, may reduce imports, but also exports, by hurting others' economies and provoking retaliation.

So is there a policy that can reconcile these otherwise irreconcilable goals? Yes, and Republicans have a golden opportunity to enact it: steep, swift cuts to federal spending. By tamping down demand and inflation, budget cuts would pull down interest rates and the dollar, reducing imports and boosting exports, while preserving the conditions for more private investment.

At its root, a trade deficit results from a country consuming more than it produces. A budget deficit contributes to this imbalance by injecting more demand into the economy via spending than it subtracts via taxes.

This linkage is why the two gaps are sometimes called twin deficits.

The link isn't fixed. Recessions reduce tax revenue and imports, while private investment booms increase them. In either case, the trade and budget deficits move in opposite directions.

But deliberately shrinking the budget deficit, via fiscal austerity, or expanding it, via fiscal stimulus, usually spills over to trade. A 2021 study of 33 countries from 1978 to 2019 by the International Monetary Fund found that for a big country like the U.S., one dollar of fiscal consolidation subtracted 30 to 50 cents from the current account balance (a broad measure of trade that includes goods, services and investment income).

Last year, the U.S. ran a federal deficit of $1.8 trillion, or 6.4% of gross domestic product. Treasury Secretary Scott Bessent has proposed reducing that to 3% by the end of Trump's term. Run that through the IMF's math, and you knock $300 billion to $500 billion off the trade deficit in goods and services, which was more than $900 billion last year.

Trade deficits aren't intrinsically bad, but if, like this administration, you disagree, you should address them in the least harmful way. Fiscal austerity does the job with much less collateral damage than tariffs. Inflation goes down instead of up. Trading

partners don't retaliate. There's no special-interest lobbying or corrosive uncertainty over who gets hit. Austerity's main drawback is that it slows growth. Countries that undertook austerity after the 2007-09 financial crisis aggravated high unemployment that central banks couldn't offset with lower interest rates, already around zero.

The U.S. is in the opposite place. Unemployment is low and inflation above the Federal Reserve 2% target. Ambitious deficit reduction would nudge inflation lower. The Fed could then cut interest rates, offsetting the drag from austerity, and weakening the dollar. Meanwhile, less federal borrowing would lower Treasury bond yields.

In this way a smaller deficit "crowds in" private investment and exports.

By contrast, experience and theory show that tariffs don't reduce the trade deficit. After Trump imposed tariffs on China in his first term, importers shifted sourcing to Mexico and Vietnam while a lower yuan helped Chinese exporters absorb the tariff.

The 25% tariffs on Mexico and Canada scheduled to take effect Tuesday have already weakened their currencies and provoked promises of retaliation. All that will sap demand for U.S. exports.

The publicly held federal debt is about to shoot past 100% of GDP. So budget deficits have to come down.

Done right, that can also reduce the trade deficit.

While higher taxes could do the job, in practice spending cuts are more effective. In the short run, a dollar reduction in, say, government benefits would reduce consumption and imports more than a dollar increase in taxes because households would respond by dipping into savings to sustain their lifestyle.

In the long run, higher tax rates discourage work and investment, leaving GDP smaller.

This happens to align with the priorities of Republicans, who want to extend 2017 tax cuts while adding new ones. But this creates some formidable math.

Extending the tax cut would leave the budget deficit at 7% of GDP in fiscal 2029, based on Congressional Budget Office and Joint Committee on Taxation estimates. To keep it at 3% would require $12 trillion of spending cuts over the next decade relative to the status quo, by my calculations. But House Republicans' budget resolution envisions only $1.5 trillion to $2 trillion of spending cuts.

(They penciled in additional deficit reduction via a growth dividend from their plans.)

Trump has made the job especially difficult by ruling out any cuts to Social Security or Medicare. Throw in interest on the debt, and half of spending is off limits. To hit a 3% deficit in 2029 would require cutting 40% from everything else—defense, homeland security, veterans benefits, Medicaid, food stamps, welfare, and countless other programs.

Zeroing out Medicaid and food stamps and firing every federal employee won't be enough.

So either Republicans put Social Security, Medicare and taxes on the table, await a growth miracle, or accept a much less ambitious deficit target.

Another caveat applies to using fiscal austerity to reduce the trade gap. As with tariffs, it doesn't work if other countries do the same. Indeed, the U.S. runs a trade gap not just because it consumes so much, but because others consume so little.

That might be changing.

The parties likely to form Germany's next government want to cut taxes and spend more on defense, power generation and infrastructure.

China's leaders are under pressure to enact fiscal stimulus.

So how about this: Germany and China agree to stimulate their economies and import more, and the U.S. agrees to shrink its own budget deficit and not impose more tariffs.

Voilà: a lower trade deficit without the trade war.

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