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OP-ED CONTRIBUTOR

Taking Aim at the Wrong Deficit

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Published: November 6, 2013

WASHINGTON — ASK most people in this city what the most important step is to increasing economic growth and job creation, and they'll reply, "Reduce the budget deficit!"

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They're wrong. So-called austerity measures — lowering budget deficits while the economy is still weak — have been shown both here and in Europe to be precisely the wrong medicine. But they could be on to something important if they popped the word "trade" into that sentence.

Simply put, lowering the budget deficit right now leads to slower growth. But reducing the trade deficit would have the opposite effect. Not only that, but by increasing growth and getting more people back to work in higher-than-average value-added jobs, a lower trade deficit would itself help to reduce the budget deficit.

Running a trade deficit means that income generated in the United States is being spent elsewhere. In that situation, labor demand — jobs to produce imported goods — shifts from here to there.

When we run a trade deficit, as we have [since 1976](#), we are spending more than we are producing. When that happens, the national savings rate goes into the red. Either private savings (by households and businesses) or government savings, or both, must be negative.

Private savings are usually near zero, with companies net borrowers and households net lenders. The exceptions came during the stock and housing bubbles, when bubble-generated wealth caused household consumption to soar and savings to drop. The housing bubble also led to a surge in home building.

That rise in investment, coupled with the fall in savings, filled the gap in demand created by the trade deficit. But after the housing bubble burst, consumption fell back to more normal levels and construction tanked as a result of overbuilding. The government stepped up and at least partially filled the gap in demand, leading to large negative savings in the public sector, or budget deficits.

In other words, we've been bouncing from investment bubble to deficit spending to offset the income that is being drained out of the economy by trade deficits. And now, with the bubble behind us and politicians obsessively focused on lowering the budget deficit, we've lost our offsets. Meanwhile, the trade deficit remains a [hefty 3 percent](#) of gross domestic product, about \$500 billion a year.

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Still, many critics argue that the budget deficit is a “policy variable” — something policy makers can control — whereas the trade deficit is set by free markets. But that view is naïve.

Many countries target the value of their currency, buying up dollars to keep their currency from rising against the dollar. This prevents normal market adjustment, as a country with a trade deficit would expect to see its currency fall in value, making its goods and services more competitive. China is the most visible and important currency “manager,” but there are many others.

These actions can be countered in at least three ways. First, we could pass [legislation](#) that gave the government the right to treat currency management as a violation of international trading rules, leading to offsetting tariffs.

We could also tax foreign holdings of United States Treasuries, making the usual tactic of currency managers more [expensive](#). And we could institute [reciprocity](#) into the process of currency management: If a country wants to buy our Treasuries, we must be able to buy theirs (which is not always the case now).

The Obama administration, however, has not taken such measures, preferring instead to try to meet its goal of doubling exports by 2015. But there’s a key word missing from that formulation: “net.”

If you asked me how my basketball team did last night, and I told you, “Great — they scored 92 points!” you’d presumably want to know how many points the other team scored. Unless we’re targeting net exports, or exports minus imports, we’re not in the game.

The administration has other helpful measures in play, including tax credits to incentivize domestic production. But unless we’re willing to go after exchange rates — the value of our currency relative to that of our trading partners — we will not be able to significantly lower the trade deficit.

The impact of doing so would be striking. Suppose the reduction in the value of the dollar cut the trade deficit by two percentage points of G.D.P. This would directly create close to 2.8 million jobs, a disproportionate number of which would be relatively high-paying manufacturing jobs. And that’s not counting the fact that a factory job has a high [multiplier](#) effect, creating more work in other sectors to support it.

If we continue to run large, persistent trade deficits, we have no good choices. We can offset that exported demand with either bubbles or budget deficits. Or we can go austere and slog along with unacceptably high levels of unemployment and weak growth.

But if we shift our focus from reducing the budget deficit to the trade deficit, we could make a big difference, not just in the national accounts, but in the lives of people for whom that unfavorable math has meant hardship for far too long.

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A version of this op-ed appears in print on November 7, 2013, on page A33 of the New York edition with the headline:
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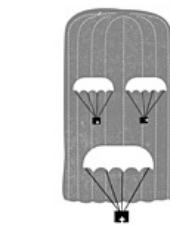
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