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"How Trump's trade policies will affect manufacturing"
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DOLLAR: Hi, I'm David Dollar, host of The Brookings Trade Podcast, “Dollar and Sense.” Today my guest is Brad Setser, senior fellow at the Council on Foreign Relations and author of “Follow the Money,” a very popular international economics blog. Our topic today is trade and American manufacturing.

Brad, you've been blogging and tweeting recently about the manufacturer's trade deficit. Can you talk a little bit about what's happening with that? Why is that happening, and is this something we should care about?

SETSER: So, the manufacturing deficit has been expanding quite significantly. It started to go up really back in 2014 when the dollar appreciated significantly against the euro, the yen, and a host of other currencies. And after the dollar appreciated, there was, in the classic way that would be expected based on a macroeconomics textbook, there was a fall in U.S. exports. U.S. exports underperformed global trade for several years and then more recently with the fiscal stimulus, the tax cuts, the increase in spending that came with lifting the spending caps, there's been another expansion in the manufacturing deficit. This time, driven much more by a rise in imports not just by a fall in exports.

The manufacturing trade balance has been moving in a different direction than the oil balance. So the overall trade balance is sort of the sum of the balance on manufacturers, the balance on oil and other commodities, and then the surplus on services. The oil deficit has come down at an incredible pace because of the surge and U.S. production.

On agricultural trade, we obviously export a lot a lot of soybeans, corn, but we also import a decent amount, more wine, and more fish. So we don't structurally tend to run a surplus there. So you know, essentially, we end up having increasingly something close to balance trade on petrol. Small deficit, now still close to balanced trade, a modest surplus in services and then by historical standards, now a quite large deficit on manufacturers.

DOLLAR: Right, so I think I saw on your blog it's heading toward about a trillion dollars at an annual rate. Is that right? And is this something we should be concerned about?

SETSER: Yes, I mean that's essentially where we will be, I think, when the data for the fourth quarter comes in. In broad terms we import about 2 trillion dollars of manufactures, or around 10 percent of our GDP. We export about a trillion, so about 5 percent of our GDP. And then the deficit is the difference 5 percent. I think you have to differentiate between how this impacts the overall economy and how this impacts specific parts of the U.S. economy. There's no question based on, I think, a lot of recent research that some parts of the country are more manufacturing intensive than others, and so those parts of the country do feel the impact of a rising manufacturing deficit.

They feel that impact much more strongly when the overall economy is weak than when the overall economy is strong. Conversely, there are parts of the country that don't specialize in producing manufactures and that see their real incomes go up because of relatively inexpensive foreign manufactured goods.

I think you have to disaggregate the U.S. economy into its component parts, and it has a differential impact on different parts of the U.S. economy. The long run concern is not limited, is it really just about manufactures. It is that, you know, the U.S. is building up a fairly substantial though denominated in our own currency stock of external debt and relative to that stock of external debt, our export base writ large, including services, is fairly modest.

DOLLAR: So you mentioned the currency issues, the rising value of the U.S. dollar. Part of that is that the U.S. economy is coming out of the global crisis a little bit better certainly than Europe or Japan. Now we have this big fiscal stimulus through the tax cut and an expenditure increases and that's pushing up interest rates and pushing up the value of the dollar. So I think implicit in that, there are things the U.S. would have to do in terms of getting its fiscal house in order to help address this issue. But then there's the issue of what our partners would do. I mean, if we did the hard things we would have to do on the macro side, you know, what are important partners, and what would they have to be doing in order to bring down these imbalances?

SETSER: So the biggest macroeconomic policy gap or gaps right now are between the U.S. and Europe, and the U.S. and some of our allies in Asia. The difference in fiscal policy between the U.S. and the euro area, taking the euro area as a whole, is I think as large as it has ever been. The U.S. fiscal deficit is around 5 percent of GDP. The European fiscal deficit is maybe a half point of GDP. But broadly speaking, pretty close to balance. That difference in macroeconomic or fiscal policy stances doesn't correspond to differences in economic conditions. If anything, the euro area has more need of a stimulus given that they've had a weaker recovery than we do since our recovery is more or less complete.

So when there's this large difference between the policy stance, that means that Europe is importing less and the U.S. is importing more and it means that monetary policy is very different on different sides of the Atlantic. You know, our interest rates are well above zero; euro area interest rates are so close to zero that interest rate differential has driven up the dollar. The same broad story can be said with variations for the U.S. and Korea. Korea has a fiscal policy that is quite tight. The Korean general government fiscal balance has a surplus of close to 2 percent of GDP. Taiwan has a tight fiscal policy. Thailand has a relatively tight fiscal policy. When you sum these smaller countries in Asia up, they turn out to add up to something that is quite substantial. So I don't think it is just a story between the U.S. and the euro area, but that's probably the easiest story to understand.

DOLLAR: But that's very interesting listening to that because a lot of the current dialogue is all about U.S.-China trade tension, and we'll get to some of that in a moment. But I agree with you the macro issues are really pretty critical, and there it's a story of the

U.S. needing to restrain our fiscal deficit and then we would need partners like the Europeans, you mentioned South Korea, you know a lot of these countries are U.S. allies. And basically what we're talking about is sensible adjustment in macro policies to make them sustainable and then it would have the effect of addressing these trade imbalances and that would help U.S. manufacturing to some extent, if I got that about right.

DOLLAR: You got that completely right. I mean, the big story writ large in the global economy over the past, let's say five years, has been that the imbalances have shifted from being between the U.S. and China and some other emerging economies to imbalances within the advanced economies. So the big surpluses globally now are in Europe, they're in Korea, Japan, Taiwan, Singapore, Thailand, pretty much all of the countries around China, but not in China per se. China has a very expansionary fiscal stance, the IMF thinks way too expansionary, and that has held down its overall trade surplus.

DOLLAR: So those are a set of macro issues that have a big effect on trade balances and implicitly on U.S. manufacturing. Now let's go down to a more micro level. I don't know if you've written about this, but I've heard you talk about some aspects of the U.S. tax code that actually discourage manufacturing production in the United States, you had a nice example of pharmaceuticals. So maybe we could talk about that a little bit?

SETSER: Yeah, I mean, I think that on the fiscal side, obviously the U.S. has pursued a very expansionary fiscal policy in the past two years, and a lot of other countries have at least, to my view, run fiscal policies that are too tight for their own good. So you need adjustments on both sides.

On the tax policy side, it’s essentially, at least in my view, a U.S. own goal. It is something we do to ourselves. The best case is pharmaceuticals. So, the U.S., obviously has world-leading companies in the pharmaceutical industry. We create many of the world’s or develop and find many of the world's most valuable pharmaceuticals, drugs. But we run an enormous trade deficit in pharmaceutical products. The trade deficit in pharmaceuticals, now on the good side, is almost as large as our trade surplus in aircraft. It's a rather stunning little fact. And what is the reason for this? You know you look at where the U.S. is importing from. It's not importing primarily from low-cost low-wage countries. The big sources of pharmaceutical imports are countries like Ireland, Switzerland, and Singapore.

And I think the reason is pretty straightforward. If U.S. companies set up manufacturing facilities in Ireland, they can lower their costs, they can lower their tax. It's a lot easier to shift your intellectual property and the profits from your intellectual property to a very low tax jurisdiction offshore if you also manufacture offshore. And unfortunately, the reforms that were passed to the corporate tax cut or they lowered the headline rate, to my mind, didn't change that incentive. The incentive to move your intangibles and your tangibles—intangibles meaning intellectual property, tangibles mean factories—offshore remain.

DOLLAR: OK, let's talk about trade policy. You know President Trump has expressed a lot of concern about manufacturing, manufacturing trade, these issues. His main weapon so far has been raising tariffs, tariffs on steel and aluminum against most of our partners. 250 billion dollars of Chinese products now being taxed, some at 25 percent, some at 10 percent. He's renegotiated NAFTA, which is potentially a positive change in trade policy. But let's talk a little bit about Trump's trade policies and how, let's focus on the tariffs, you know, how does that affect manufacturing? Does that help us manufacturing production, does that… how does that affect U.S. manufacturing trade?

SETSER: Well, I mean, so far, the visible effect of Trump’s broader policies has been a great stimulus to our manufacturing trading partners, our imports of manufactures are actually way up under Trump because the effect of Trump's stimulus has overwhelmed the effect of his trade actions to date. For each individual trade action, you can tell an individual story about what is happening in that sector. But in aggregate, you end up telling the story of macro-economic stimulus and policy differences. No one doubts Trump's commitment to bringing manufacturing back home at a rhetorical level, but he hasn't matched that with macroeconomic policies that would deliver. And his trade policies so far haven't.

Take steel. The steel tariffs have, I think, increased U.S. steel production somewhat. They've certainly increased the profits in the steel industry. They've raised the price of U.S. made steel, in part because, you know, U.S. made steel competes with foreign steel, and foreign steel is now much more expensive. Does that change the manufacturing trade surplus? Not necessarily. We're importing a little less steel, but because the price of steel has gone up and steel is an input into so many other goods, we probably will end up exporting fewer washing machines, fewer cars, fewer of the goods that use steel. So I don't think you can tell a simple story where if you protect one sector, the overall result is always a reduction in the overall trade deficit. You may reduce the deficit in that sector, but raise it elsewhere. That's certainly the case I think with steel and with aluminum.

NAFTA is a slightly more complicated story. U.S. trade between Mexico and Canada has been very balanced. There really isn't a true issue, it's not like U.S. trade with Europe, U.S. trade with Korea. U.S. trade with China. Mexico and Canada, like the U.S., run overall trade deficits. But there has been a shift in auto production towards Mexico over the past 10 years tied to the weakness in the Mexican peso and structural shifts, structural shifts of a very profound kind. Mexico is no longer really an oil exporter and the U.S. is no longer really an oil importer. And so Mexico can't make its living exporting oil to the US. So Mexico, economically, has migrated more towards manufacturing and more towards the auto sector, and that has put some pressure on U.S. jobs in the auto sector. I think NAFTA, the renegotiated NAFTA, the USMCA, is a combination of an update of a 20 year old agreement that had a lot of provisions that were a little bit out of date. Sensibly could be updated and a set of new restraints to kind of throw a little sand in the wheels of this shift in auto production towards Mexico. But on the whole, I think it's a useful, don't want to go so far to say it's constructive because I think that's debatable, but it's certainly better that we have a new NAFTA or USMCA than to not be in North American trade agreement.

DOLLAR: So I want to echo your point about the fact that we import a lot of the manufactures we import from inputs into production, you use the steel example. But in our trade with China, about 37 percent of what we import are parts and components, and then some additional amount would constitute capital equipment bought by firms. So when we put these tariffs on these products, they end up hurting U.S. firms that use them as inputs. Some of those are manufacturing firms, so as you say, there's no presumption this is going to change the trade balance in a particular direction, and there's no presumption that this is going to change the manufacturing trade balance in that particular direction because some of the firms that are hurt by this are manufacturing firms.

SETSER: You know, on the China stuff, I have a slightly different point of view, which is that if you look at the areas where there's still overlap between what China produces and what the U.S. produces, and where there's a realistic possibility of substitution back to the U.S., the bulk of those are in the intermediate goods space. So obviously it's a tradeoff, there are costs, but if you compare the protection on intermediate goods, at least there, I think there's some possibility of stimulating U.S. production. Think of some items like big producers of diesel engines which are importing engines and parts from China. That's still a sector where the U.S. has a viable domestic manufacturing industry. I think as you go into the consumer goods space, just because of the structure of trade with China, you enter into sectors where there isn't really much U.S. production. So if you're going to take action against China, at least in my view, the cost-benefit tradeoff is actually a little better in intermediate goods even taking into account that you're raising the cost of producing the final goods in the U.S.

DOLLAR: So, following the meeting between Xi Jinping and Donald Trump on the sidelines of the G-20 meeting, the U.S.-China trade war seems to be on hold at least temporarily. There's a 90-day truce and the two sides are supposed to negotiate now on some of the difficult structural issues that affect trade, and U.S. Trade Representative Bob Lighthizer will be heading up U.S. negotiations. So I'm wondering if you have much optimism for these talks between China and the U.S.?

I should mention Brad and I used to work in the U.S. Treasury together, so we have a long history of being involved at least on the sideline of negotiations between China and the United States. So do you see much chance for progress? What is China likely to do and is that going to have a big effect on manufactures trade for the U.S. in either direction?

SETSER: So, maybe we can start by working backwards. What are the Chinese policies that have the biggest effect on U.S. manufacturing? Number one by far is the value of China's currency, which is only indirectly going to be a subject, I think, of this round of talks. But when you think about what impacts incentives across a whole range of industries, about whether to make investments in China, or serving the U.S. market, or investments in Mexico to serve the U.S. market, or investments in the U.S. to serve the U.S. market, the currency ends up being the most important variable. The other policies that I think have a significant impact are the set of policies where China effectively makes it impossible to serve the Chinese market without producing in China, and then in turn, informally, conditions investment in China on technology transfer to Chinese firms which in the long run, can lead to the development of competitors both in the Chinese market, and in some cases in the global market.

What types of policies does China use to do that? Well first, China's still has relatively high tariffs, maybe not in comparison with other emerging economies, but certainly higher tariffs in the U.S. and the EU and Japan. That creates an incentive obviously to jump over the tariff wall and produce in China for the Chinese market. China has a set of informal government policies that work through China's state sector that favor Chinese production over imports. Think about Chinese state hospitals. Do they buy imported medical equipment or do they buy domestically produced medical equipment? And if they buy domestically produced medical equipment, do they favor domestic Chinese firms over foreign firms that are producing in China? Think about China's government-run airlines which ultimately are the purchasers of all aircraft. Historically, they had to choose between Boeing and Airbus, and they kind of typically split it. But they always tried to condition orders on setting up a factory in China. Airbus got into the Chinese market by setting up an A320 line in China which now kind of cuts a little bit into U.S. exports of aircraft. And now China is going to, through subsidies, develop its own aircraft manufacturer, which will ultimately I think have an impact on Boeing's market share.

You can go on. China wants an indigenous semiconductor industry. Semiconductor and semiconductor designs are an important U.S. export. So you end up focusing I think if you want to focus on policies that impact manufacturing on the tariffs, on the JV requirements, informal and not legal by China type preferences. And then on the systematic subsidies that China provides to its firms in sectors where it's seeking to develop. Now that's a very hard agenda to negotiate on. And that's I think why one should be cautious in your expectations about what can be achieved in the next 90 days.

DOLLAR: Another question I want to ask you, Brad, is about auto tariffs. President Trump is proposing to put 25 percent tariff on autos and auto parts, I think it is a critical part of this policy. And it's somewhat speculative, but I thought we could talk a little bit about what might very well happen. The typical car has 15,000 parts and you really do have global value chains now with parts coming from all different directions. So what's likely to happen is this going to be helping U.S. manufacturing, hurting U.S.

manufacturing? Is it going to be neutral, and we may not see this policy, but it's good to think about it before we have a public debate about whether to implement it.

SETSER: To be honest, I think we should just aggregate global supply chains a little bit. There is a predominantly North American supply chain, there is a predominantly Asian supply chain, and there is a predominantly European supply chain. Each of those supply chains, they probably need a few components from one another, but each of those is complete in the sense that within North America there is probably capacity to produce almost all of the parts that you need to create a car. The, by implication if you disentangle or if you broke up the North American supply chain by pulling out of NAFTA, that would be uniquely damaging to the North American supply chain, and almost certainly, at least in my view, be a negative shock, not a positive shock.

So I do think that protecting the existing North American supply chain is important. Assuming that the tariffs only apply to trade with Europe, trade with Japan, trade with Korea, the effect, I think, would be a strong incentive for those countries' auto firms to increase their U.S. production, particularly if the tariffs are on final fully assembled cars, not on parts. But even if they're on parts, the incentive would be to use, to the extent that you can, the North American supply chain or to develop the North American supply chain. So I do think that if we really went to a 25 percent tariff on autos, we would end up importing fewer autos from Japan, from Germany, from Korea. Over time we would also pay more for the cars we drive. So it's a straightforward trade.

The broader impact depends on how other countries respond. They would almost certainly retaliate. So we would lose exports in other sectors, and if other countries are exporting less to us, they're earning less foreign currency. And you can imagine that their currencies would be under pressure to depreciate which would also tend to make it harder for us to export and to compete around the world. So I think you know you end up with a rather a classic result where protection can, if implemented effectively, with a cost, increase production in the protected sector. But at the expense of other parts of the economy.

DOLLAR: Well, thank you, Brad. This has been fascinating. I've been here with Brad Setser talking about, I said trade in manufacturing, but we ended up talking a lot about international economics, currency, macro policies, and also tax and trade policy. So thank you very much Brad.

SETSER: Thanks so much for having me.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of “Dollar and Sense” every other week. So if you haven't already, make sure to subscribe on Apple Podcasts or wherever else you get your podcasts and stay tuned.

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