

Trump vs. Krugman on Trade Wars

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Dean Baker, 23 March 2018

Paul Krugman used his [column](#) this morning to go after Donald Trump for rushing blindly into a trade war. While I agree with Krugman's basic points, Trump does not seem to know what he is doing and therefore this is not likely to end well, I would disagree with Paul on a few points.

First, Krugman makes the point that the Commerce Department's measure of our trade deficit with China is overstated because it counts the full value of exports from China as coming from China, even though most of the value added may come from elsewhere. This could mean, for example, we count the full value of an iPhone exported from China as a Chinese export, even though the vast majority of the price is attributable to components made elsewhere.

Krugman is clearly right on this but ignores the flip side. When we import goods from Japan, Korea, Germany and other countries, some of the price will reflect the value of parts that were manufactured in China. My guess is the amount of foreign value added in our imports from China is probably larger the amount of Chinese value added in our imports from third countries, but the latter is clearly not zero.

If we want to do an honest accounting to determine our true trade deficit with China, we have to look at both sides of this issue. It is interesting to note the lack of interest in this value-added issue when it comes to our trade with Canada.

As my friend Lori Wallach [pointed out to me](#), the US actually does have a trade deficit with Canada (as Trump claimed) if we pull out the value of re-exports. These are goods imported to the US from countries like Germany, which are immediately shipped through to Canada. For example, if 1000 Volkswagens are offloaded in New York and then 100 are sent up to Canada to be sold there, the 100 cars are re-exports that would be counted as exports in the Commerce Department data. An honest assessment of our trade with Canada would pull out these re-exports.

The second point concerns the value of China's currency. China quite openly acted to deliberately hold down the value of its currency in the last decade when it bought up massive amounts of foreign currency (mostly dollars) to keep the value of the yuan from rising against the dollar. In more recent years, it has stopped buying dollars and even sold some of its reserves. Most economists see this as meaning that China is no longer deliberately depressing the value of its currency.

I disagree with this assessment since China still has an enormous stock of foreign exchange. Its central bank holds more than \$3 trillion in foreign exchange. In addition, the country has a sovereign wealth fund with foreign assets of more than \$1.5 trillion for a total of \$4.5 trillion. We might expect a normal country of China's size to hold around \$1 trillion in reserves.

This difference of \$3.5 trillion in holdings has the effect of depressing the value of the yuan in the same way that the Federal Reserve Board's holdings of \$4 trillion of assets helps to keep down interest rates. In other words, China is still managing its currency in a way that increases its trade surplus. As a practical matter, we would ordinarily expect a fast-growing developing country like China to be a net importer of capital, which means it would run a trade deficit.

China's current trade surplus is considerably smaller than it was in the last decade, but it is reasonable to expect it to flip to a deficit. The fact that China already did have a very large reduction in its surplus, while maintaining very strong growth, indicates that further reductions are a reasonable demand on the country.

Finally, Krugman seems to share the view that "we" should want China to respect our intellectual property claims. (In fairness, he qualifies this point somewhat by saying that Trump wants China to respect our intellectual property claims.) This is far from obviously the case.

Patents, copyrights, and other forms of intellectual property are what makes items like prescription drugs and software expensive. These government-granted monopolies can raise the price of the protected items by factors of ten or even a hundred, making them equivalent to tariffs of many thousand or tens of thousand percent.

Patent and copyright monopolies also redistribute income upward. The great philosophical question I like to pose is "how rich would Bill Gates be if Microsoft had no patent or copyright protection on Windows and other software?" The best guess is that he would still be working for a living.

Anyhow, there are other mechanisms for financing innovation and creative work which are arguably more efficient and also lead to less inequality. ([Here](#) is a discussion of the issue. See also Chapter 5 of my [free] book *Rigged: How Globalization and the Rules of the Modern Economy Were Structured to Make the Rich Richer*.) While US trade policy has been very much focused on imposing ever longer and stronger intellectual property rules on our trading partners (and locking them in domestically) it is not clear that most of us benefit from this policy, even though Pfizer and Microsoft surely do. If Trump's trade battles allow us to re-evaluate this part of our trade policy, it will have served a useful purpose.

But just to be clear, I very much agree with Krugman's basic point. Trump shows zero evidence of having any idea what he is doing. He is angering our allies and trading partners for no obvious goal. That is not a story that is likely to have a happy ending.