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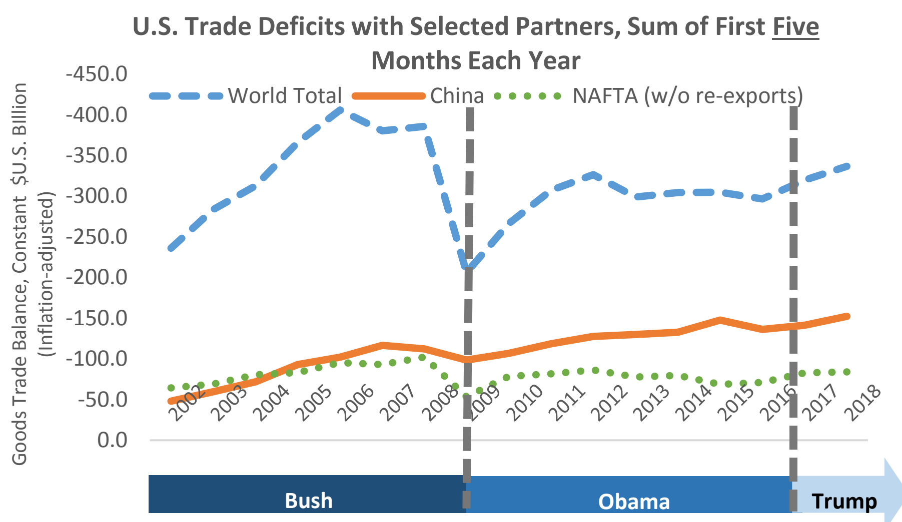
REPORTER MEMO

U.S. Trade Deficit for First Half of 2018 Likely to Be Largest Recorded in Years, With China Deficit on Track to Be Highest First-Half *Ever* Recorded

January-June 2018 Data Out This Friday Likely to Show a Trump Trade Deficit Higher Than First Halves of 2017 or 2016

WASHINGTON, D.C. – Contrary to Donald Trump's claim last week that he has reduced the trade deficit by $52 billion, the United States is on track to post a record high goods trade deficit for the first half of 2018. When the U.S. Census Bureau releases the six-month data this Friday, the global deficit and China deficit are likely to be higher than in the first half of Trump's first year in office, which was higher than the first half of President Barack Obama's last year. The six-month 2018 North American Free Trade Agreement (NAFTA) deficit also is likely to be higher than the first half of Obama's last year.

Trump's $52 billion trade deficit reduction claim seems to be premised on a misleading comparison between an annualized change in the goods and services trade balance between the first quarter of 2018 (a $902 billion deficit) and the second quarter of 2018 (a $850 billion deficit.) But the U.S. goods trade deficit in the first quarter of 2018 was [the largest first-quarter deficit since before the financial crisis](), meaning a decline from that in the next quarter says very little about the overall trend. This comparison, like changes in month-to-month deficit figures that often are reported in the press, obscure actual trends. The monthly data are volatile, especially now, as U.S. exporters race to beat retaliatory tariffs on U.S. goods. Reviewing the same five-month goods trade balances shows that U.S. deficits with the



Source: U.S. Census Bureau

world and with China were higher over the first five months of 2018 compared to the first five months of 2017, which in turn were higher than the first five months of 2016, even after adjusting for inflation. (All figures in this memo are inflation-adjusted, so they represent the actual growth in the deficit expressed in constant dollars.)

What to Look for When Census Releases the Six-Month 2018 Trade Data on Friday

- ***The goods trade deficit with China over the first half of 2018 is on track to be the highest first-half ever recorded.*** Comparing the first five months of Trump's first year in office to his second, the China goods trade deficit increased 8 percent from $141 billion in 2017 to $152 billion in 2018. This compares to $136 billion for the first five months of 2016, Obama's last year. As was widely reported, U.S. exports were inflated during the first half of 2018 by shipments racing to get ahead of the imposition of tariffs, but imports also grew substantially.

- ***The goods trade deficit with the world over the first half of 2018 is likely to reach a level closer to the record deficits before the 2008-09 financial crisis***. The U.S. trade deficit with the world over the first five months increased 5 percent from $320 billion in 2017 to $336 billion in 2018 after already hitting $296 billion in 2016, the last year of Obama's term. The 2008 first five-month deficit, before the effect of the crisis was felt, reached a record $385 billion before falling to $206 billion in 2009 for the same period.

- ***The six-month 2018 NAFTA goods trade deficit may also increase in Trump's second year, as it did in his first relative to Obama's last year in office.*** The NAFTA deficit for the first five months of 2018 increased from $70 billion in 2016 to $82 billion in 2017 to $84 billion in 2018. Because re-exports now represent 20 percent of U.S. goods exports to NAFTA nations, for the NAFTA figures we use domestic export data. This excludes goods not actually produced in the exporting country. In 2016, 44 percent or nearly $100 billion of U.S. re-exports went to NAFTA partners – $53.5 billion to Mexico and $45.7 billion to Canada. No other country received more than 6 percent of U.S. re-exports. Not removing re-export artificially inflate export figures.

Why Month-to-Month Trends Miss the Main Story

Many trade watchers focus on the change in month-to-month numbers, especially now as they study whether newly imposed tariffs are altering trade flows. But monthly trade figures are volatile, and the "seasonal adjustment" done by Census does not control for factors such as U.S. exporters trying to beat the imposition of various countervailing tariffs. Thus, the main storyline when the May trade figures were released was that the monthly deficit with the world was the lowest since October 2016. But missing in this assessment was that U.S. trade deficits with the world and with China were higher during the first five months of 2018 compared to the same period in 2017, which were in turn higher than the first five months of 2016, even after adjusting for inflation. A more complete picture of U.S. trade balance trends is achieved by comparing the year-to-date totals through the same point of previous years. This removes the need for seasonal adjustment, given the data cover the same months each year. (We focus on goods balances rather than total goods and services in this memo because services data broken down by trading partner lags the goods data by months. The services data by partner for the first half of 2018 will not be available until September 2018.)

NAFTA Balances and the Skew from Re-Exports: Yes, We Have A Deficit With Canada

Accurately accounting for NAFTA trade balances is complicated. Since NAFTA went into effect, the share of U.S. exports to Mexico and Canada that are re-exports of goods made in other countries has jumped from 5 percent in 1993 pre-NAFTA to 20 percent in 2017. (Re-exports are goods imported, for instance, from China into the United States and then exported to Canada without change. In 2016, one-third of U.S. re-exports to Canada were produced in China.) Counting re-export of foreign-made goods in U.S. export data inaccurately inflate export numbers. But to get an accurate balance, the import side of the equation also must be considered. The United Nations' trade database, called Comtrade, provides official government data on domestic exports (i.e., not including re-exports). Consider the controversial question of whether the United States has a trade deficit with Canada. The Comtrade data show $221 billion in U.S. domestic exports to Canada and $266 billion in Canadian domestic exports to the United States in 2016, the most recent year that can be compared to available services data. That yields a $45 billion U.S. goods trade deficit with Canada. After subtracting the $24 billion U.S. services trade surplus with Canada documented by the U.S. Bureau of Economic Analysis, the United States still had a $21 billion goods and services trade deficit with Canada in 2016. When this issue came to the forefront earlier this year, analysts who did not subtract re-exports instead calculated a $7 billion U.S. surplus with Canada for 2016.

A Deeper Dig into the Data: About Those Soy Exports

Several deeper cuts of the data are worth considering. The first relates to what the United States is exporting, which to the world in 2017 was $138 billion of agricultural goods and $1.1 trillion of manufactured goods. There has been breathless coverage of how China's retaliatory tariffs have impacted U.S. soybean exports, which are noted to be the second largest U.S. export to China after civilian aircraft, engines and parts. What this reveals is the lack of U.S. value-added exports to China after that nation's accession to the World Trade Organization (WTO). After soybeans, the top 15 U.S. export products to China include commodities like crude oil (No. 4), copper scrap (No. 7), propane (No. 8), aluminum scrap (No. 11), wood pulp (No. 12), cotton (No. 14) and paper waste (No. 15). The giant trade deficit with China is the result of exporting only $120 billion worth of goods in total. However, a large portion are low value-added commodities. Of the top 15 U.S. export products to China, $24 billion represent such goods, and only $31 billion, or 56 percent, represent high value-added product categories like cars and electronics. Meanwhile, 84 percent of Chinese imports into the United States are in these high-value categories. The United States runs over a $100 billion deficit with China in electrical machinery alone.

The second deep dive relates to the impact on wages from the composition of the goods we import and export. One way to view this is by checking the subset of the data on our manufacturing trade balance. Even the most orthodox economists admit that trade changes the composition of jobs – and thus the wages – available for U.S. workers. As the grandfather of modern trade economics, Nobel-Prize winning economist Paul Samuelson found in one of the last papers he published before his death, offshoring of higher-paid jobs to countries like China and India can cause U.S. workers to lose more in wages than they gain from access to cheaper imported goods. The downward pressure on wages is still the predominant feature of the U.S.

labor market and trade is one of the significant factors fueling it and one of the only ones that can be altered via policy changes. The Center for Economic and Policy Research (CEPR) revealed that when comparing the lower prices of cheaper imported goods to the income American workers lost from low-wage competition under current trade policy, by 2001 the trade-related wage losses were larger than gains from access to cheaper goods for the majority of U.S. workers. CEPR found that those without college degrees (58 percent of the workforce) had likely lost an amount equal to 12.2 percent of their wages under NAFTA-style trade, even after accounting for the benefits of cheaper imports. That meant a net loss of more than $3,965 per year for the average worker. Despite this, defenders of the trade status quo dismiss the relevance of trade deficits, especially given strong economic growth figures in an economy running near full employment. Yet, while headline economic indicators are strong, damage that is occurring may remain invisible. When the tide goes out on a hot economy, the damage in lower wages and the disappearance of middle-class jobs for the majority of Americans without college degrees may be seen and felt acutely, just as it was after the 2008-09 financial crisis.

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