Paul Krugman

How to think about trade imbalances

On Thursday, January 30, Paul Krugman joined Markus' Academy for a conversation. Paul Krugman is Professor Emeritus at Princeton University, the Distinguished Professor of Economics at the Graduate Center of the City University of New York and the 2008 recipient of the Nobel Prize in Economics.

A few highlights from the discussion.[1]

A summary in three bullets

- A new view of trade imbalances, exemplified by Pettis and Hogan (2024), has gained traction in policy circles and think tanks, arguing that these imbalances are a distortion due to government-actions, hurt deficit countries, and should be addressed with tariffs
- There are several problems with this new view. Trade need not be imbalanced if some countries can attract investment better than others. It is also not clear that imbalances lead to deindustrialization, nor that a large manufacturing sector should be a policy objective
- Tariffs are never the solution. We know two things about tariffs: (1) they lead to retaliation and (2) will strengthen the dollar, hurting the U.S.'s exports

[00:00] Markus' introduction

- The first China shock in the 2000s saw the country exporting mostly to the U.S.. Despite having 17% of global GDP, China accounts for 29% of manufacturing but only 13% of global consumption. Was the erosion of the U.S.' industrial base because of the first China shock or technological change?
- We have seen a second China shock as, amidst its recession, China has doubled down on exports. Tordoir and Setser (2025) show that Chinese demand for German exports has collapsed, while in a recent MA episode Richard Baldwin argued that China is shifting toward import substitution
- If more industries now exhibit increasing returns to scale, countries will be more incentivized to do industrial policy to leverage this scale and gain standard setting power
- For deficit countries, the key trade-off in industrial policy is cheap imports vs. deindustrialization. Jaravel & Sager (2019) estimate that U.S. consumer surplus grew by $400K for every displaced job
- The U.S. can sustain a permanent current account deficit due to its exorbitant privilege: it issues a bubble-like safe asset that foreigners demand for self-insurance. This allows the U.S. to finance its deficits without a real repayment burden (Brunnermeier and Merkel, 2024)

[06:17] Addressing a new view about trade imbalances

---

[1] Summary produced by Pablo Balsinde (PhD student, Stockholm School of Economics)

- A new view of trade imbalances, exemplified by Pettis and Hogan ([2024]), has gained traction in policy circles and think tanks, arguing that these imbalances are a distortion due to government-actions. It can be summarized in four points:
- (1) Trade is supposed to be more or less balanced, where countries should export some goods in order to import others
- (2) Trade imbalances are caused by distortionary policies
- (3) These distortionary policies harm the trade deficit-running countries
- (4) Tariffs are an appropriate response
- Though interesting, it is mostly a wrong set of ideas. Historically, the first point is largely untrue. During the globalization of the 19th century the UK ran large current account surpluses
- Taylor and Obstfeld ([2003]) show a stylized evolution of capital mobility in modern history. Before WWI capital was extremely mobile, with large flows into settler colonies (e.g. Australia, US, Argentina). After WWII private capital flows effectively stopped due to capital controls, and did not recover to pre-WWI levels until the 2000s
- It was only in the post-WWII period that trade was balanced (with the U.S. having balanced trade until the 80s). Crucially, balanced trade was only possible because of government intervention
- The new view's second point argues that the U.S. deficits reflect the role of the dollar as the reserve currency, whereby the country is forced to run trade deficits because countries who intentionally run surpluses want to hold reserve assets
- Illustrated by the new view's emphasis on the Triffin Problem, this is a 1950s/1960s view of the world
- Trade imbalances need not originate because of government distortions. Any country that can attract foreign capital can run persistent current account deficits
- While the U.S. enjoys some exorbitant privilege, it is not unique in its persistent deficits; other countries like the UK and Australia have done so as well
- The new view is right that in China, where capital controls exist, the current account balance is largely a policy choice, driven by intentional trade surpluses and a reluctance to redistribute income to workers (leading to weak domestic demand)
- Someone must indeed run the counterpart deficit to China. The U.S. does so, but the dollar being the reserve currency is only part of the story
- China buying reserve assets should appreciate the dollar, but if the dollar is overvalued shouldn't capital flow for example towards Europe? Shouldn't China's surplus ultimately also appreciate the euro against the renminbi?
- Capital flowed to the U.S. due to its technological success. It was its TFP surging from 1995 to 2005 due to the IT revolution (which the U.S. benefited comparatively more from) that led to its current and trade account deficits

[34:02] Is deindustrialization a problem?

- The third point of the new trade view is that trade imbalances hurt the deficit countries because they contribute to their deindustrialization
- Manufacturing capacity is crucial for national security, but the belief that it provides the best jobs is outdated. Non-supervisory manufacturing wages now are lower than the private sector average (with only a modest premium after demographic adjustments)
- Manufacturing once offered better pay due to strong unions, but these have been weakened and there has been no unionization in the large service companies

- More broadly, the extent to which deindustrialization stems from trade imbalances remains an open question
- In 2023, Germany's manufacturing trade surplus exceeded 20% of GDP, while the U.S. had a manufacturing trade deficit of just over 4% of GDP
- Despite this, Germany's GDP remains at pre-COVID levels, while U.S. GDP is 10% higher. While demographics play a role, their experience suggests that trade surpluses and strong manufacturing alone do not guarantee economic success
- We tend to overstate industrial global strategic mistakes underestimate the real challenges: weak productivity growth, demographics, and low infrastructure investment
- Germany's ability to diversify away from Russian natural gas shows that modern advanced economies are more diversified and flexible than often assumed.

[43:02] Is there a case for tariffs?

- If one believes that trade imbalances are a result of government distortions, that trade surpluses drive deindustrialization, and that deindustrialization is bad, one may be sympathetic to tariffs
- However it is not clear that the size of the manufacturing sector should be a policy objective. Strategic industries are a different matter, and subsidies may be more effective for these
- Even assuming a larger manufacturing sector is desirable, do tariffs achieve them?
- We know two things about tariffs: (1) they lead to retaliation and (2) they would strengthen the dollar
- By reducing U.S. demand for imports they lower the supply of dollars flowing to foreigners. A stronger dollar makes U.S. exports more expensive, offsetting some of the intended benefits of tariffs
- Tariffs and currency devaluations are not equivalent. Devaluations contract imports and expand exports, while tariffs restrict imports but also hurt exports through the exchange rate channel
- Because of this channel, Lerner's (1936) symmetry theorem suggests that an import tax functions like an export tax—while having imbalanced trade complicate this, the principle has a lot of truth in it
- If trade imbalances stem from interventionist surplus countries, tariff threats are not a rational tool to force them to change policy. Doug Irwin (2012) showed this is what Nixon did to get countries to revalue their currencies against the dollar, ultimately leading to the end of Bretton Woods
- As Richard Cooper (1977) argued. The danger of US protectionism is not relation but emulation
- Further, Clausing and Lovely (2024) show that tariffs are fully passed on to consumers (though pass-through estimates can be misleading as they typically rely on partial equilibrium analysis)

[51:15] Q&A

- It is unclear whether other countries can emulate China's experience of growing through manufacturing
- We used to worry about China not being able to follow Taiwan or S. Korea's path because there had to be a limit to global demand for manufacturing

- China’s success relied on the rise of global value chains, which broadened manufacturing opportunities
- The countries most most vulnerable to American tariffs are smaller ones like Bangladesh and Vietnam. The E.U. and China will be able to manage, while Canada and Mexico can cause the U.S. enough pain that it might back down
- Internal (within-firm) economies of scale are less important today than they used to be
- External (across-firms or sectoral) economies of scale have always been large, but now they are especially relevant in higher value added (per worker) sectors like tech and finance
- Acknowledging that returns to scale may have grown and the rising importance of strategic sectors strengthens the case for industrial policy
- China’s export patterns may largely reflect comparative advantage, and partly increasing returns to scale (e.g. many industrial clusters like the Pearl River Delta).
- Small countries can achieve increasing returns by specializing in a single sector. This is less-risky if one is a part of a trade bloc
- Are tariffs on services possible? Yes, they may require a different administration, but remember that tariffs are fundamentally a sales tax. Countries could impose sales taxes on services from overseas
- Classic economic analysis, dating back to Max Corden’s 1977 *Trade Policy and Economic Welfare*, argues that even with market failures, policies should be as surgical as possible
- A tariff is effectively a subsidy plus a sales tax, making direct subsidies the more targeted policy. A world of subsidy wars is less harmful than a world of tariffs, especially for smaller countries. Tariffs are never the right answer
- We tend to think that globalization inevitably rises absent protectionism. However it represents a race between the technology of transportation and that of production
- We have seen integration historically because transportation technology has progressed faster. AI, as a production technology advancement, competes with service offshoring. India may have made a mistake by betting on the outsourcing of services

Timestamps:
[00:00] Markus’ introduction
[06:17] Addressing a new view about trade imbalances
[34:02] Is deindustrialization a problem?
[43:02] Is there a case for tariffs?
[51:15] Q&A