Wackonomics

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April 1 is well-known as the day for jokes. April 2 now has its own moniker, as Liberation Day for the forces of inflation and recession. On that fateful day Donald Trump substantially increased the probability of a 21st century repetition of the 1930s Great Depression. The remarkable trade tariff initiatives of the American president are based on a revolutionary new school of economic thought that can best be referred to as Wackonomics*.*

Unless you have lived on Mars or Venus for the past weeks, you must be aware of **president Donald Trump's head-on assault on the free trade order**. This same order has brought humankind enormous benefits since the end of the Second World War. The 2 April announcement of a barrage of tariffs imposed on exports from all over the world to the United States will bring, so a triumphant Donald Trump declared on his self-proclaimed **Liberation Day**, investments, jobs and increased welfare to the American citizenry.

Doubling up. Emphasis on downside

A cursory reading of history, together with a basic grasp of the elementary principles of political economy, shows that this triumphalism is totally misplaced. Tariffs on imports of the magnitude announced by Donald Trump will beyond any doubt lead to retaliation by most of those hit by those tariffs (which basically means the rest of the world). As we most painfully learned during the Great Depression of the 1930s, such an escalating trade war fundamentally destabilizes the economic and financial system and augments the risks of political chaos considerably. In the present circumstances a word wide trade war will not only fuel the forces of recession (or worse) but also of inflation. Doubling up, and an emphasis on downside. ***The Economist*** was, as usual, very much to the point by redefining ***Liberation Day*** as ***Ruination Day Ruination Day****.* To avoid such bleak scenarios, it is imperative that the rest of the world keeps its cool (cfr infra).

----*"A total denial of basic economic knowledge."*----

It is more than a pity that the tariff assault launched by Donald Trump is based on a **total denial of basic economic knowledge**. This gives rise to my reference to all of this as ***Wackonomics*** (wacko being, according to the Oxford English dictionary, a combination of madness and insanity). Let me be very straightforward: **we are not dealing here with ideologically inspired differences of opinion on a policy issue like trade tariffs. No, not at all. We are dealing with denial of an economic identity that holds always and everywhere, whatever your ideology. Let me explain.**

Looking at GDP

The starting point is the definition of Gross Domestic Product (GDP). GDP represents the value of all the goods and services produced in an economy in a year and can be further defined in three ways: the total of: net final sales, the total added value created, and the streams of income generated in the economy. Taking the first perspective produces, per definition, the following equation:

$$Y = C + I + G + (X - M) \qquad (1)$$

where Y stands for final net sales (GDP), C for final sales of consumption goods and services, I for final sales of investment goods (and additions to inventories), G for final sales to the government expenditures, X for sales to the rest of the world (total exports) and M for sales of imported goods and services. These imports represent a leak of domestic income and hence have to be deducted. (X – M) represents the trade balance, the most important part of the current account of the balance of payments of a country.

In modern-day international economic statistics (X – M) catches the full current account of a country's balance of payments. This contains all the transactions between a country and the rest of the world. The other part of the balance of payments is the capital account. Since the balance of payments needs per definition to be "in balance", a deficit on the current account necessitates an equivalent surplus on the capital account, meaning that the country with a deficit on the current account will need to have import of capital (whether spontaneously or induced through government intervention). Countries showing a surplus on the current account will per definition be exporters of capital.

The third way to define GDP (or Y) is the streams of income approach. The incomes generated within the economy can be used in three ways. They can be consumed (C), saved (S) or paid in taxes (net of transfers made by the authorities to its citizens), usually represented by the symbol T. Hence:

$$Y = C + S + T \qquad (2)$$

Given (1) and (2) it can of course be written that

$$C + I + G + (X - M) = C + S + T \qquad (3)$$

Some simple mathematical manipulation of equation (3) leads to the following basic macroeconomic identity:

$$(S - I) + (T - G) = (X - M) \qquad (4)$$

Identity (4) shows that the position of the current account (deficit, surplus or in equilibrium) is linked to the domestic private savings (S), private investments (I) and the government's budgetary balance (T – G). A word of caution here: equation (4) is an identity that tells us little about causation. Nevertheless, from a policy point of view important insights and conclusions can be drawn from this basic macroeconomic identity.

Sectoral Balances 2023	**Private Balance (S-I)**	**Government Balance (T-G)**	**Current Account (X-Z)**
United States of America	4,3	-7,6	-3,3
Germany	8,4	-2,2	6,2
China	8,8	-7,4	1,4
Netherlands	10,1	-0,2	9,9
Euro Area	4,8	-3,1	1,7
Source: NBB			

The accompanying table shows the data of the composing parts of equation (4) for the United States and a few other countries in 2023. The US had a current account deficit equal to 3.3% of GDP. The private saving surplus (S – I) amounted to 4,3% of GDP but was insufficient to cover the government budget deficit equal to 7.6% of GDP. Hence there was a massive capital import as a counterpart to the deficit on the current account. **China shows a government budget deficit very close to the one of the United States**, i.e. 7.4% of GDP. However, in China the private saving surplus is more than double that of the US and more than covers the budget deficit. Hence, a current account surplus and capital export. Germany has a private saving surplus very close to the Chinese one and a much smaller government deficit (2.2% of GDP). Hence a huge current account surplus (6.2% of GDP) and a massive capital export. The Netherlands are even more extreme: an enormous private savings surplus, practically no government deficit and hence a monstrous current account surplus.

Beside the point

President Trump has hardly given one speech, campaigning or otherwise, in which he didn't get in a rage on the persistent current account deficit of the US. It is indeed true that the US has been running a current account deficit for decades. Here the causation issue raises its head. **Is that current account deficit the result of persistent budget deficits and insufficient private savings, or is it the other way round?** The fact is that foreigners in the past have been eager to invest in US assets for several reasons. The dominance of the dollar in international trade and finance, the growth performance of the American economy, the depth and liquidity of American financial markets and the rule of law in the US have all influence positive inflows. Accordingly, capital imports necessitated a current account deficit and allowed the US government to run almost systematic budget deficits, given the limited net savings generated by the American private sector. This situation has since the 1960s time and again been referred to as the "exorbitant privilege" of the United States.

Where all this becomes ***Wackonomics*** is where one starts arguing that tariffs on the trade partners will cure the current account deficit. They will only do so if and when they lead to a reduction in the internal spending in the US. Translated to the scheme developed above, tariffs will have to lead to higher internal private savings and/or a much lower government budget deficit. Higher internal net savings means higher saving ratios and/or lower investment, hence a recession. A smaller budget deficit would of course also contribute much to the reduction of the current account deficit, but Donald Trump is pursuing policies which in the coming five years will further increase systematically the budget deficit. As an aside, it is becoming increasingly clear that **Elon Musk**, hailed as Trump's deus ex machina to massively improve efficiency within the American government bureaucracy, is not really succeeding in this task, even on the contrary. **Trump totally ignores the most logical measure available to him to pursue a guaranteed reduction of the so hated current account deficit, namely a substantial reduction of the American government budget deficit.**

Hence *Wackonomics*: there is no way tariffs will reduce the American current account deficit given the other policy options pursued by the Trump administration. Above all, imposing massive import tariffs will drive up American prices and hence handicap the competitiveness and export capabilities of American companies. Of course, the recession and inflation outburst that will follow the unfolding trade war can lead to such dramatic changes in patterns of savings, investment and government deficits in the US and elsewhere that current account balances will also change. The direction of such changes is impossible to predict at this time. Nevertheless, what can be predicted with great certainty is that such adjustments will play out in a world that is not only in political turmoil but also in deep economic and social crisis. "***The global economy"***, so **Mohamed El-Erian**, president of Cambridge's Queens College and chief economic advisor at insurance group Allianz, concluded, **"is on a bumpy road to an unknown destination"**.

The *Editorial Board* of the ***Financial Times*** summarized it all succinctly by defining Trump's reciprocal tariffs assault on the rest of the world as ***"one of the greatest acts of self-harm in American history. They will wreak untold damage on households, businesses and financial markets across the world, upending a global economic order that America benefited from and helped to create"***.

It doesn't stop here

Is using tariffs and a trade war to eliminate a current account deficit the only chapter in the *Wackonomics* manual? Unfortunately not. The way in which the specific tariffs for the different countries and regions were calculated constitutes another chapter in this manual. I don't dig deeper into this subject since others have done the job well. The bottom line is that the methodology used to calculate the different tariffs is deeply flawed and does not make any economic sense at all. The discount or halving of rates as an act of "kindness" only underlines the unseriousness of the exercise.

A third chapter in the *Wackonomics* manual consists of a theme that is still under discussion within the Trump administration. If translated into policy reality it risks becoming even more destabilizing than the tariff craze. **This third section in the *Wackonomics* manual is focused on the US Treasuries market**, the bedrock of the international financial system. Treasury Secretary **Scott Bessent** and even more **Stephen Miran**, chairman of the Council of Economic Advisors in the Trump White House, are the cheerleaders for this part.

Their line of argument starts with the thesis that the dollar is persistently overvalued and hence a drag on the competitiveness of the American corporate sector. Dollar overvaluation arises from foreigners' eagerness to buy US assets, especially US Treasuries. To cure this situation considered hugely unfair towards the United States, so Bessent and Miran's thinking goes, foreign investors would need to be managed more forcefully in the direction of serving America's interest. Hence the idea to tax foreign investors buying US treasuries in combination with pressuring with whatever means available foreign holders of US Treasuries to transfer to perpetual dollar bonds. What all this is supposed to lead to is twofold. First, a lower dollar exchange rate. Second, holding on to sufficient foreign capital inflow into the United States to allow Washington to keep running considerable budget deficits.

The above reasoning and consequent policy proposals truly deserve to be described as *Wackonomics*. As outlined above, the US is as dependent on foreign capital flowing into the US as foreigners are eager to come to the deep and liquid American financial markets. The volatile and counterproductive policies of the Trump administration are rapidly undermining this attractiveness of dollar assets. The attempts of the same administration to undermine rule of law only accelerate this investment re-evaluation. For the time being investors still flee in large numbers to US Treasuries (as many did in the hours after Trump's tariff assault) but more and more question are asked.

The Bessent-Marin thinking will undoubtedly seriously disturb the US Treasury market and hence also the entire financial system. One thing is for sure: that disturbance will push up interest rates, in the US and most probably also worldwide. Further consequences are harder to predict in precise ways, but all scenarios under discussion lack good news. As one international banker told me: ***"If these proposals are pushed through, we enter in a very dark room"***.

Be transactional

Realizing that the economic policies emanating from the Trump White cannot be described but as being based on *Wackonomics* is one thing, the other and more important thing is how best policymakers outside the United States should react to it all. Focusing on the tariff assault launched on the rest of the world, it seems rather obvious to me that we Europeans should do damage control. A full-scale trade war is certainly not in our economic, social or political interest. So immediate and substantive retaliation, as the Chinese government did, is not the most sensible reaction. Much more interesting and productive is the "we take note" reaction of the Swiss authorities.

Our reaction should take fully into account that despite the economic unorthodoxy underpinning efforts, it is rather obvious that the tariff assault is most of all a repeat of the negotiation tactic that Trump uses all the time: shock your adversaries and partners with wild actions and declarations so that they are intimidated when they come to the negotiating table. The tariff moves can be seen as a negotiating chip to be played with to achieve results that have more to do with power and security than with … economic re-balancing, tariff policy and even Rust Belt America. Also never forget that Trump is a transactional man focused on doing deals he perceives to be valuable. Highly indicative of this Trumpian approach is his reaction to China's immediate retaliatory action. ***"China played it wrong – they panicked!",*** so Trump wrote on his social media platform. We must reflect carefully on what can be offered to Trump, and wider US political constituencies, in this transactional context and try to make sure that such offers are to the benefit of all concerned and inspire the American president to move on from tariffs and find a new speech to riff on relentlessly.