America’s Maligned and Misunderstood Trade Deficit

By Daniel Griswold  
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America’s annual trade deficit, already large by historical standards, could reach a new record in 1998, fueling protectionist sentiment in Congress. Political fallout from the trade deficit numbers could impede efforts to reduce barriers to trade in the United States and abroad.

Contrary to popular conception, the trade deficit is not caused by unfair trade practices abroad or declining industrial competitiveness at home. Trade deficits reflect the flow of capital across international borders, flows that are determined by national rates of savings and investment. This renders trade policy an ineffective tool for reducing a nation’s trade deficit.

A survey of America’s major trading partners reveals no relationship between bilateral trade balances and openness to U.S. exports. For example, the U.S. runs a bilateral surplus with Brazil, which is relatively protectionist, while we run deficits with Canada and Mexico, which are almost totally open to U.S. exports thanks to the North American Free Trade Agreement.

There is no connection between trade deficits and industrial decline. From 1992 and 1997, the U.S. trade deficit almost tripled, while at the same time U.S. industrial production increased by 24 percent and manufacturing output by 27 percent. Trade deficits do not cost jobs. In fact rising trade deficits correlate with falling unemployment rates. Far from being a drag on economic growth, the U.S. economy has actually grown faster in years in which the trade deficit has been rising than in years in which the deficit has shrunk. Trade deficits may even be good news for the economy because they signal global investor confidence in the United States and rising purchasing power among domestic consumers.

What matters to the economy is not the difference between imports and exports but the extent to which Americans are free to benefit from the efficiencies, opportunities and consumer choice created in an economy open to world trade.

Introduction

One of the most politically volatile consequences of the financial and economic turmoil in the Pacific Rim will be a rising U.S. trade deficit in 1998. Plunging growth rates in the region will mean less demand for U.S. exports, while falling foreign currency values will make Asia’s exports to the United States more affordable, spurring demand by American consumers. The result, widely predicted by economists, will be a mercantilist’s nightmare: a growing gap between the value of the goods and services we import and the value of what we export. The U.S. merchandise trade deficit in 1998 could approach $250 billion, breaking the record of $198.7 billion just set in 1997.\(^{(1)}\) If the past is any guide, the growing trade gap will fuel anguish in the news media and protectionist sentiments in Congress.

Whenever the government announces a record, or just a rising, deficit, the media routinely declare the “bad news” that the trade gap has “worsened”—no matter how good the accompanying economic news may be on inflation, employment, and growth. Media reports were typically gloomy in February when the Commerce Department reported a $114 billion trade deficit for 1997, the largest trade gap since 1988. On February 19, the day of the report, Dan Rather announced on CBS News that “the government says the 1997 U.S. trade deficit was the worst in nine years.”\(^{(2)}\) The same day, Lou Dobbs, host of CNN’s Moneyline program, said, “We begin tonight with today’s troubling report on trade, a report that showed the nation’s trade deficit soared by 24 percent in December.”\(^{(3)}\) The next day, the Wall Street Journal added darkly that “1998 could shape up to be an even more dismal year for trade than 1997.”\(^{(4)}\)

No aspect of international trade is talked about more and understood less than America’s perennial trade deficit. Critics of free trade, and most Americans for that matter, believe the trade deficit is prima facie evidence that American companies are failing to compete in global markets or that U.S. exporters face “unfair” trade barriers abroad, or both. The obvious implication is that, if other nations were to open their markets as wide as we have supposedly opened ours, or if American companies became more competitive, we would run a trade surplus. But there is no evidence that this would happen. The best that can be said is that the trade deficit may be lower if we opened our markets wider. The problems are deeper than that.

The trade deficit is not a problem in itself. What matters to the economy is not the difference between imports and exports but the extent to which Americans are free to benefit from the efficiencies, opportunities and consumer choice created in an economy open to world trade. The trade deficit is a symptom of deeper problems, not a cause. The real issue is whether the country’s openness to world trade is enough to ensure maximum efficiency and productivity in world markets.

The trade deficit, in short, is not a problem that can be solved by trade policy. The real problem is whether we are opening ourselves enough to world trade. The real question is whether we are being unfair to other nations or unfair to ourselves. The answer is no. The United States has opened its markets more than any other nation in the world. It is the United States, not other nations, that is the problem.
Other nations were to open their markets as wide as we have supposedly opened ours, or if American companies became more competitive against foreign rivals, we could export more relative to imports, thus reducing the trade deficit.

The popular thinking on trade deficits is simple, appealing—and wrong. Trade deficits are not determined by the microeconomics of trade policy or industrial competitiveness. They reflect underlying macroeconomic factors, specifically investment flows and, ultimately, the national rates of savings and investment that determine those flows. The recent experience of the United States and its trading partners confirms this conclusion.

Understanding the trade deficit has profound implications for our national debate about trade. We cannot reduce the U.S. trade deficit by restricting imports to the American market or by persuading or bullying other governments to lower barriers to their markets. We cannot reduce the trade deficit through government-directed industrial policy, managed trade, or export subsidies aimed at boosting national “competitiveness” (however one defines the concept). And, contrary to the headlines, trade deficits are not necessarily bad news for the U.S. economy. They may even be good news.

Current Accounts, Current Controversies

Americans have run an annual trade deficit in goods and services with the rest of world in every year since 1976. That unbroken string of deficits has colored much of the trade debate in the United States in the last two decades.

Beginning in the early 1980s, annual U.S. trade deficits reached unprecedented levels. After decades of postwar surpluses, the U.S. trade deficit topped $100 billion in 1984 and peaked at a record $153 billion in fiscal year 1987. The trade deficit shrank to a low of $31 billion in 1991, but it has grown again to more than $100 billion a year since 1994, reaching $113.7 billion in 1997. (The $198.7 billion deficit in goods last year was offset by an $85 billion surplus in services.)

Throughout the 1980s and 1990s, trade deficits have spawned worry about “unfair” foreign trade barriers, lost jobs, and America’s ability to compete in the global marketplace. Indeed, the trade deficit was partly to blame for a wave of angst in the late 1980s over American “decline.” Best-selling books such as Paul Kennedy’s *The Rise and Fall of the Great Powers* and Clyde Prestowitz’s *Trading Places: How We Allowed Japan to Take the Lead* caught the mood of the time.

In the mid-1980s lawmakers on Capitol Hill responded to the trade-deficit anxiety with protectionist-leaning proposals. In 1986 the House approved by a two-to-one margin an amendment offered by Rep. Richard Gephardt (D-Mo.) that would allow the imposition of import quotas against countries that were running large bilateral trade surpluses with the United States. (Japan, Taiwan, and West Germany were considered the most likely targets at the time.) The amendment passed the House again in 1987, by a narrow margin, although it was ultimately excluded from the 1988 Omnibus Trade and Competitiveness Act in favor of the “Super 301” law threatening retaliation against countries engaged in allegedly unfair trade practices.

In November 1991 Gephardt tried again, proposing an amendment that would activate Section 301 sanctions against any nation whose bilateral trade surplus with the United States accounted for more than 15 percent of the total U.S. trade deficit. “Like the original Gephardt amendment of 1986-88, this proposal exploited two widely shared beliefs: that nations ought normally to balance their trade bilaterally, and that deficits were caused, in important part, by the surplus country’s barriers to imports,” observed trade scholar I. M. Destler.

The trade deficit has continued to haunt U.S. trade policy in the 1990s. In the debate in the fall of 1997 over renewal of fast-track trade authority, opponents of the measure cited the continuing overall U.S. trade deficit as evidence that trade harms the U.S. economy and destroys jobs. To discredit the North American Free Trade Agreement, and by association all free-trade agreements, opponents of fast-track authority hammered away at the bilateral trade deficits the United States runs with both of its NAFTA partners, Mexico and Canada.

The deficit with Mexico drew the most fire because America’s bilateral balance with Mexico had been in surplus before 1995. In September 1997 Steve Beckman, an economist for the United Auto Workers labor union, testified before the Subcommittee on Trade of the House Ways and Means Committee that bilateral trade deficits with Canada and Mexico had created a “trade debacle” costing the U.S. economy more than 400,000 jobs.

Bilateral trade deficits continue to complicate America’s commercial relations with a number of major trading partners, chief among them Japan and China. In 1997 the United States recorded a $55.7 billion bilateral trade deficit with Japan and a $49.7
billion deficit with China, by far our two largest bilateral imbalances. The deficit with China appears even more threatening to some trade critics because it has grown so rapidly in recent years, more than quadrupling from $11.5 billion in 1990. Our bilateral deficit with China has been used to argue against renewal of China’s Most Favored Nation status and against admitting it to the World Trade Organization. America’s bilateral trade deficit with Japan has probably been the single biggest source of trade friction between the two countries.

If the overall U.S. trade deficit rises in 1998 as predicted, it could spur a whole new round of attacks on free trade, prompting government intervention to curb imports and spur exports.

Understanding the U.S. Trade Deficit

The trade deficit has been at the heart of one of the oldest debates in economics. The mercantilist approach to trade that dominated thinking in the 17th and 18th centuries stressed the need for nations to accumulate gold. By exporting more than they imported, nations could hoard the excess money, almost always gold or silver, generated by the trade surplus. A treasury bulging with precious metals was considered the true sign of a nation’s wealth and might. The more metallic money a state possessed, the more able it would be to wage war if necessary.

Predictably, the obsession with running a positive “balance of trade” led to all sorts of protectionist measures and export subsidies. High tariffs and outright import bans were the rule among European nations before 1800.

Back to Smith and Hume

In arguing for free trade, the 18th-century classical liberals David Hume and Adam Smith attacked what Hume called “a strong Jealousy with regard to the balance of trade.” Hume reasoned that a nation’s supply of gold was ultimately determined by its capacity to produce wealth, not the other way around. A nation that attempted to accumulate gold through a trade surplus, by either blocking imports or subsidizing exports, would soon find that its gold stocks were rising in relation to the total goods available for sale. That excess of money would cause a general rise in the price of domestic goods (i.e., inflation), making them less appealing to foreign buyers. As long as prices kept rising, demand for exports would fall until the inward flow of gold ceased. As Hume understood two centuries ago, any attempt to manufacture a trade surplus through trade policy was doomed to fail because the flow of money would be self-correcting.

Hume’s contemporary and friend Adam Smith also dismissed worries about the trade deficit. “Nothing can be more absurd than this whole doctrine of the balance of trade,” he wrote. What mattered to Smith was not the difference between exports and imports but the gains from specialization that trade allows. Those productivity gains allow a nation’s residents to produce goods and services of a higher total value—the only true measure of a nation’s economic wealth. Any interference in the freedom to trade, no matter what its effect on the trade balance, diminishes that wealth. “A trade which is forced by means of bounties [subsidies] and [protected] monopolies may be, and commonly is, disadvantageous to the country in whose favor it is meant to be established. But that trade which, without force or constraint, is naturally and regularly carried on between any two places, is always advantageous, though not always equally so, to both.” Smith and Hume’s critique of the balance of trade doctrine remains valid two centuries later.

Investment Flows Drive the Deficit

The most important economic truth to grasp about the U.S. trade deficit is that it has virtually nothing to do with trade policy. A nation’s trade deficit is determined by the flow of investment funds into or out of the country. And those flows are determined by how much the people of a nation save and invest—two variables that are only marginally affected by trade policy.

An understanding of the trade deficit begins with the balance of payments, the broadest accounting of a nation’s international transactions. By definition, the balance of payments always equals zero—that is, what a country buys or gives away in the global market must equal what it sells or receives—because of the exchange nature of trade. People, whether trading across a street or across an ocean, will generally not give up something without receiving something of comparable value in return. The double-entry nature of international bookkeeping means that, for a nation as a whole, the value of what it gives to the rest of the world will be matched by the value of what it receives.

The balance of payments accounts capture two sides of an equation: the current account and the capital account. The current account tracks the value of goods and services that a country buys and sells. The capital account tracks the net flow of investment funds, including direct investments, portfolio investments, and official reserve transactions. A surplus in the current account (i.e., more exports than imports) indicates that a country is accumulating foreign assets. A deficit in the current account (i.e., more imports than exports) indicates that a country is financing its imports with foreign savings. A surplus in the capital account indicates that a country is receiving more investment funds than it is paying out. A deficit in the capital account indicates that a country is paying out more investment funds than it is receiving.

The overall balance of payments is the sum of the current and capital accounts. If the overall balance of payments is a surplus, the country is accumulating foreign assets. If the overall balance of payments is a deficit, the country is financing its imports with foreign savings. In either case, the overall balance of payments is determined by the flow of investment funds, not by trade policy. The trade deficit is simply one of the many factors that determine the flow of investment funds into or out of a country.
The balance of payments accounts capture two sides of an equation: the current account and the capital account. The current account side of the ledger covers the flow of goods, services, investment income, and uncompensated transfers such as foreign aid and remittances across borders by private citizens. Within the current account, the trade balance includes goods and services only, and the merchandise trade balance reflects goods only. On the other side, the capital account includes the buying and selling of investment assets such as real estate, stocks, bonds, and government securities.

If a country runs a capital account surplus of $100 billion, it will run a current account deficit of $100 billion to balance its payments. As economist Douglas Irwin explains, “If a country is buying more goods and services from the rest of the world than it is selling, the country must also be selling more assets to the rest of the world than it is buying.”

The necessary balance between the current account and the capital account implies a direct connection between the trade balance on the one hand and the savings and investment balance on the other. That relationship is captured in the simple formula:

\[\text{Savings} - \text{Investment} = \text{Exports} - \text{Imports}\]

Thus, a nation that saves more than it invests, such as Japan, will export its excess savings in the form of net foreign investment. In other words, it must run a capital account deficit. The money sent abroad as investment will return to the country to purchase exports in excess of what the country imports, creating a corresponding trade surplus. A nation that invests more than it saves—the United States, for example—must import capital from abroad. In other words, it must run a capital account surplus. The imported capital allows the nation’s citizens to consume more goods and services than they produce, importing the difference through a trade deficit.

In 1996 Americans invested $1,117 billion privately and another $224 billion through government, for a total of $1,341 billion in gross domestic investment. National savings, however, fell short of that amount, requiring Americans to import a net $133 billion in capital.

That same year Americans paid $1,238 billion to the rest of the world for imports of goods and services, net transfer payments, and income on foreign investments in the United States, while receiving $1,105 billion for exports and investment income. The result was a current account deficit of $133 billion, equal to the net inflow of foreign capital.

The transmission belt that links the capital and current accounts is the exchange rate. As more net investment flows into a country, demand rises for the dollars needed to buy U.S. assets. As the dollar grows stronger relative to other currencies, U.S. goods and services become more expensive to foreign consumers, reducing demand, while imports become more affordable to Americans. Falling exports and rising imports adjust the trade balance until it matches the net inflow of capital. In effect, foreign investors will outbid foreign consumers for limited U.S. dollars until the investors satisfy their demand for U.S. assets. Of course, most day-to-day currency transactions are not directly related to trade, but demand for U.S. goods, services, and assets affects demand for the dollars needed to buy them, thus influencing the value of the dollar in global currency markets.

Germany in the early 1990s offers a case study of how this mechanism works. West Germans routinely ran large current account (and trade) surpluses in the 1980s, but between 1990 and 1991 Germany’s current account flipped from a surplus of 3.2 percent of gross domestic product to a deficit of 1.0 percent. The reason for the reversal was not that German manufacturers suddenly lost their legendary efficiency, or that Germany’s trading partners imposed new and unfair trade barriers on the night of December 31, 1990. What caused the switch was the huge increase in domestic investment needed to rebuild formerly communist eastern Germany. An increase in domestic investment repatriated a huge amount of German savings that had been flowing abroad, thus reducing the amount of German marks in the foreign currency markets and raising their value relative to other currencies. The stronger mark, in turn, raised the price of German exports and lowered the price of imports, evaporating Germany’s trade surplus.

In an October 1997 study for the Economic Strategy Institute, economist Peter Morici attempts to offer an alternative explanation for the trade deficit. A press release accompanying the study dismisses “the old chestnut that the current account is simply the other side of an immutable accounting identity.” As evidence, Morici cites the effect on the trade deficit caused by the purchase of U.S. assets, in particular Treasury bills, by foreign governments.

Morici’s analysis is not a refutation of the accounting identity but a restatement of it. Whether the transaction involves a private foreign investor’s buying shares in IBM or a foreign government’s buying T-bills, it still counts as an inflow of foreign capital to the
United States. Indeed, Morici’s own regression analysis finds that changes in the U.S. trade balances are strongly correlated with private investment flows. “Overall variations in private sector behavior appear to be more important than direct measures of either U.S. or foreign government policies,” he concluded. “Among private variables net foreign private investment (NFPI) seems to explain more of the variation in the trade and current accounts balances than the domestic private savings balance.”(22) In other words, the old chestnut still rings true: investment flows drive the trade deficit.

Why Protectionism Cannot Cure the Trade Deficit

The causal link between investment flows, exchange rates, and the balance of trade explains why protectionism cannot cure a trade deficit. In his 1997 book, One World, Ready or Not, Washington journalist William Greider proposes an “emergency tariff” of 10 or 15 percent to reduce the U.S. trade deficit.(23) If Congress were to implement that awful idea, American imports would probably decline as intended. But fewer imports would mean fewer dollars flowing into the international currency markets, raising the value of the dollar relative to other currencies. The stronger dollar would make U.S. exports more expensive for foreign consumers and imports more attractive to Americans. Exports would fall and imports would rise until the trade balance matched the savings and investment balance.

Without a change in aggregate levels of savings and investment, the trade deficit would remain largely unaffected. All the new tariff barriers would accomplish would be to reduce the volume of both imports and exports, leaving Americans poorer by depriving them of additional gains from the specialization that accompanies expanding international trade.

Government export subsidies would be equally ineffective in reducing the trade deficit. Partly in response to the Asian financial crisis, President Clinton proposed in his 1999 federal budget an increase in subsidies to U.S. exporters through the Export-Import Bank. By allowing certain exporters to lower their prices on sales abroad, the subsidies would stimulate foreign demand, but the greater demand for dollars needed to buy U.S. goods would bid up the dollar’s value in foreign exchange markets. The stronger dollar, in turn, would raise the effective price of U.S. exports generally, offsetting any price advantage gained by the subsidies. Total exports, and hence the trade deficit, would remain unchanged. Subsidies only divert exports from less favored to more favored sectors.

In theory, trade policy can indirectly affect the trade deficit by influencing a nation’s level of savings and investment. For example, a higher tariff would presumably raise government revenue through additional customs duties, thus reducing the budget deficit (or increasing the surplus) and reducing the need to borrow from abroad—resulting in a smaller trade deficit. But a tariff can also stimulate investment in the protected industry, increasing demand for foreign capital and leading to a larger trade deficit.

After surveying the various theories, Labor Department economist Robert C. Shelburne concluded, “Trade policy is likely to have a marginal impact on savings or investment and thus only a marginal impact on the trade balance.”(24) Even Morici concurs, noting that “changes in trade policies have had minimal effects on aggregate net exports in recent years.”(25)

Another temptation is to intervene by intentionally devaluing the national currency in the foreign exchange market. A nation’s central bank can put downward pressure on the value of its own currency by creating an excess amount of that currency and using the excess to purchase foreign currencies. A falling currency can stimulate exports and dampen demand for imports, thus reducing a trade deficit. However, a cheaper currency also means that asset values in that country drop in foreign currency terms, attracting foreign investment flows that increase the capital account (and the corresponding current account deficit). And eventually the weaker currency feeds back into the domestic economy in the form of higher overall prices, that is, inflation. In the long run, higher domestic prices will offset any price advantage gained in the international marketplace by a “competitive devaluation.”

Proven Trade-Deficit Cutter: A Recession

One way to reduce the trade deficit would be for Americans to save more. A larger pool of national savings would reduce demand for foreign capital; with less foreign capital flowing into the country, the gap between what we buy from abroad and what we sell would shrink.(26)

A related way to cut the trade deficit is for the government to borrow less. Reducing the government deficit (a form of “dissaving”) releases more funds for domestic investment, reducing the demand for foreign capital. That explains the “twin deficits” phenomenon of the 1980s, when huge federal budget deficits claimed a rising share of national savings, requiring the importation of the missing savings from abroad to sustain our consumption.

By lowering the demand for foreign capital, a smaller budget deficit frees funds for domestic investment. And by reducing the demand for foreign capital, a smaller budget deficit lowers the exchange rate, making American goods cheaper relative to foreign goods. The lower exchange rate, in turn, raises the demand for U.S. exports and reduces the demand for imports, thus reducing the trade deficit.

At the time this was written, the Clinton administration was in the process of solving both problems by fixing the budget deficit through tax increases and spending cuts—both of which are now in place. The government is running a (slight) surplus, and the trade deficit has dropped by almost half.
of savings from abroad to meet domestic demand for investment. The inflow of foreign capital prompted by the budget deficit allowed Americans to buy even more goods and services than they sold in the international marketplace. As the federal budget deficit declined in the late 1980s, so too did America’s trade deficit.

Another, less appealing way to reduce the trade deficit is to reduce investment. That occurs more or less naturally during times of recession, when business confidence falls and companies cut back on expansion plans. As Americans consume and invest less, demand for imports and foreign capital falls along with the trade deficit. That explains why the smallest U.S. trade deficit since the early 1980s occurred in 1991, in the midst of the most recent recession. In fact, as Figure 1 illustrates, the U.S. current account balance tends to shrink during times of recession and grow during economic expansions. If the trade deficit really is one of our nation’s most pressing problems, the surest and swiftest way to tackle it would be to engineer a deep recession.

That is exactly what happened to Mexico in 1995. In the aftermath of the peso crisis, Mexico’s real GDP shrank in 1995 by 6.2 percent. Because of falling domestic demand, fleeing capital, and a plunging peso, Mexico’s overall trade balance flipped from a deficit in 1994 to a surplus in 1995. Mexico’s bilateral balance with the United States did the same, going from a deficit to a surplus. That supposed “trade debacle” for the United States had nothing to do with NAFTA or any other change in trade policy. It was caused by mismanagement on the part of Mexico’s monetary authorities, and the chief victims of that mismanagement were Mexican workers. Perhaps NAFTA critics who believe our bilateral trade deficit with Mexico is such a terrible development would have preferred that the U.S. economy, not the Mexican economy, contract 6.2 percent in one year. Of course, American workers would have suffered, but it would have done wonders for our bilateral trade balance.

An understanding of the all-important role of investment flows should liberate trade policy from its obsessive focus on the current account balance. The trade deficit is not a function of trade policy, and therefore trade policy cannot be a tool for reducing the trade deficit.

**Enduring Myths about the Trade Deficit**

Misunderstanding of the U.S. trade deficit has spawned a number of myths about international trade and America’s place in the global economy. Those myths have allowed trade deficits to be used to further a number of anti-trade and anti-market positions, including export subsidies, industrial policy, and sanctions against “unfair” trading partners. The following are among the most common and harmful myths surrounding the trade deficit.

**Myth: “U.S. Exporters Face Unfair Trade Barriers”**

Many Americans are convinced that a bilateral trade deficit proves that the foreign country’s market is relatively closed to U.S. exports compared with the “open” U.S. market. America’s large bilateral deficit with Japan is almost unanimously seen as a problem by U.S. policymakers who share that view, with blame for the deficits placed squarely on “unfair” foreign trade barriers.
A survey of America’s major trading partners challenges that assumption. Countries with which the United States runs large deficits are not characteristically more protectionist toward U.S. exports than are those with which we run a surplus. Canada and Mexico, two countries that are very open to U.S. exports thanks in part to NAFTA, are both among the five countries with which the United States has the largest bilateral trade deficits. On the other side, America’s third largest bilateral trade surplus is with Brazil, a country whose barriers to imports remain relatively high. Americans face a common external tariff when exporting to members of the European Union, yet some EU members (the Netherlands and Belgium) are among the top surplus trade partners, and others (Germany and Italy) are among the top deficit partners. Trade policy cannot explain those differences (Table 1).

### Table 1
America’s Top 10 Bilateral Deficits and Surpluses 1997
(billions of U.S. $)

<table>
<thead>
<tr>
<th>Country</th>
<th>Deficit</th>
<th>Country</th>
<th>Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>-$55.9</td>
<td>Netherlands</td>
<td>+$12.5</td>
</tr>
<tr>
<td>China</td>
<td>-$49.8</td>
<td>Australia</td>
<td>+$7.4</td>
</tr>
<tr>
<td>Germany</td>
<td>-$18.7</td>
<td>Brazil</td>
<td>+$6.3</td>
</tr>
<tr>
<td>Canada</td>
<td>-$17.9</td>
<td>Belgium</td>
<td>+$5.5</td>
</tr>
<tr>
<td>Mexico</td>
<td>-$14.4</td>
<td>Hong Kong</td>
<td>+$4.8</td>
</tr>
<tr>
<td>Taiwan</td>
<td>-$12.2</td>
<td>United Kingdom</td>
<td>+$3.8</td>
</tr>
<tr>
<td>Italy</td>
<td>-$10.4</td>
<td>Argentina</td>
<td>+$3.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-$7.2</td>
<td>Egypt</td>
<td>+$3.2</td>
</tr>
<tr>
<td>Venezuela</td>
<td>-$6.8</td>
<td>Chile</td>
<td>+$2.1</td>
</tr>
<tr>
<td>Nigeria</td>
<td>-$5.5</td>
<td>South Korea</td>
<td>+$1.9</td>
</tr>
</tbody>
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Blaming bilateral deficits exclusively on differences in trade policy once again misses the reality of investment flows. In Japan, high domestic savings rates provide a pool of capital that far exceeds domestic investment opportunities. Japan “exports” capital to the United States, which allows Americans to import more goods from Japan than we export. The main reason that America’s bilateral trade deficit with Japan exploded in the 1980s is that the Japanese government lifted many of its capital controls with the passage of the Foreign Exchange and Foreign Trade Control Law in December 1980. That allowed a tsunami of Japanese savings to flow across the Pacific to the United States, where it could draw a more favorable rate of return.

Despite the common perception, Japan was actually more open to U.S. exports in the 1980s than in the 1960s and 1970s, when American bilateral trade deficits with Japan were much smaller. As Robert T. Parry, president and chief executive officer of the Federal Reserve Bank of San Francisco, explained:

> Of all the U.S. trading partners, Japan continues to be singled out for having the most unfair trading practices. But it’s doubtful that such policies have been a major cause of U.S. trade deficits. First of all, the Japanese market has become somewhat more open—not more closed—over the past decade. Second, Japan’s share of changes in the total U.S. non-oil merchandise trade deficit has been proportional to its U.S. trade share. For example, in 1981, about 9 percent of our exports went to Japan, and about 20 percent of our imports came from Japan. That left us with a bilateral deficit of $16 billion. If the same shares prevailed in 1992, we would have had a bilateral deficit of $57 billion—which is in fact a little larger than the actual deficit of $51 billion. So I think there’s not much evidence to say that restrictive trade practices have been the driving force behind changes in the U.S. trade deficit.[28]

The same cannot be said for our bilateral deficit with China. Despite substantial progress in the last 10 years, its barriers to imports remain relatively high. Those barriers partly explain the bilateral surplus China runs with the United States, but the primary explanation is more benign: We like to consume the products China sells. In 1995 the Council of Economic Advisers concluded, “China’s persistent surplus with the United States in part reflects its specialization in inexpensive mass-market consumer goods. China similarly runs bilateral surpluses with Japan and Europe for this reason.”[29]

If China were to further open its market, America’s bilateral deficit with China would probably shrink, but our overall trade deficit—determined by aggregate savings and investment—would remain largely unaffected. A rising dollar caused by increased demand for U.S. exports to China would lead to larger bilateral deficits (or smaller surpluses) with other U.S. trading partners. If
demand for U.S. exports to China would lead to larger bilateral deficits (or smaller surpluses) with other U.S. trading partners. If the United States were to impose higher tariffs aimed at imports from China (say, by revoking its Most Favored Nation status), that too might reduce the bilateral deficit, but not the overall U.S. trade deficit. Higher tariffs against Chinese imports would merely shift some of the bilateral trade deficit to other countries while raising prices for American consumers.

Myth: “America Is Losing Its Competitiveness”

In 1992 the Cuomo Commission on Competitiveness labeled the trade deficit one of America’s 10 most urgent economic problems. “Because of American industry’s declining competitiveness and our openness to the global economy, the economic demand spurred by the federal budget deficits in the early 1980s precipitated a huge flow of imports,” the commission concluded in its report, which simply assumed a connection between trade deficits, openness, and competitiveness.(30)

The “competitiveness” myth has gone into remission in recent years. Since the Cuomo Commission report, the United States has enjoyed seven consecutive years of healthy, noninflationary growth along with historically large and rising trade deficits. Meanwhile, Japan and Germany, the two export-driven juggernauts that were supposed to eclipse the United States as economic powers in the 1990s, have struggled with slow growth and rising unemployment.

America’s experience in both the 1980s and the 1990s refutes any connection between trade deficits and a loss of industrial might. Figure 2 shows that industrial production in the United States has climbed steadily in the past two decades during a time of historically large U.S. trade deficits.

Figure 2
The Trade Balance and Industrial Production

![The Trade Balance and Industrial Production](image)

Between 1980 and 1987, when the U.S. current account deficit was rising to a peak of 3.6 percent of GDP, U.S. industrial production rose by 17 percent and total manufacturing output by 23 percent.(31) The same story has repeated itself in the 1990s. Between 1992 and 1997 the annual U.S. trade deficit almost tripled, from $39 billion to $114 billion.(32) Meanwhile, since 1992 total industrial production in the United States has surged by 24 percent and manufacturing production by 27 percent.(33) In Japan during the same period, industrial production has grown by only 8 percent, and in Germany growth has been less than 1 percent.(34) America runs substantial bilateral trade deficits with both countries.

America is the world’s number-one trading nation in both imports and exports. Between 1992 and 1997, U.S. exports of goods and services surged from $617 billion to $932 billion. The reason the trade deficit has grown is that imports have increased even faster, from $657 billion to $1,046 billion.(35) By any definition, the ability of American industry to compete in the world has not suffered because of a rising trade deficit. The experience of the 1980s and 1990s points in quite the opposite direction.

Myth: “Trade Deficits Mean Lost Jobs”

A study by the Institute for Policy Studies in January 1998 predicts that the larger trade deficit caused by the East Asian financial meltdown will cost the U.S. economy more than 1 million jobs. Columnist Patrick Buchanan, when running unsuccessfully for the Republican presidential nomination in 1996, offered his own, back-of-the-envelope estimate of jobs lost because of the trade gap: “Our merchandise trade deficit was $175 billion (in 1995). For every $1 billion, you get 20,000 jobs. That’s 3.5 million American workers who would have had good manufacturing jobs if we simply had a trade balance.”(36) Both estimates are based on a fundamental misunderstanding of the relationship between trade and aggregate employment in the United States.

The total number of jobs in the United States is largely determined by fundamental macroeconomic factors such as labor-supply growth and monetary policy. Trade with other nations does not reduce the number of jobs, but it does quicken the pace at which changes occur.
growth and monetary policy. Trade with other nations does not reduce the number of jobs, but it does quicken the pace at which production shifts from one sector to another. Trade, like new technology, lowers demand for some jobs while raising demand for others. Trade allows the United States to produce more Boeing jetliners, pharmaceuticals, software, and financial services for export, but trade also means we produce fewer shoes, T-shirts, Happy Meal toys, and computer memory chips. Meanwhile, total output and total employment keep growing.

In reality, larger trade deficits correlate positively with falling unemployment. Figure 3 illustrates how closely the unemployment rate corresponds with changes in the U.S. trade deficit. When the trade deficit expands, as it did in the 1980s, unemployment falls. When the deficit shrinks, as it did during the 1990-91 recession, the unemployment rate rises. As the trade deficit has expanded in the 1990s, the unemployment rate has fallen steadily. The unemployment rate fell in all but 2 of the most recent 14 years in which the trade deficit grew larger than it had been the previous year (1976-78, 1982-87, 1992-94, 1996-97).(37) As an expanding economy creates jobs, it also creates demand for imports and for capital from abroad.

Figure 3
The Trade Balance and Unemployment

There is no reason to believe that eliminating the trade deficit would create any gain in manufacturing jobs, never mind 3.5 million. With the U.S. economy already operating at a low level of unemployment, it is not clear where 3.5 million new manufacturing workers would come from. And as we have already seen, a protective tariff to close the trade deficit would only succeed in reducing exports as well as imports, thus eliminating manufacturing jobs in the export sector. If Buchanan’s calculations had any meaning, we should expect to see a fall in manufacturing employment during periods of rising trade deficits. Recent economic trends tell a different story. Since 1993 the U.S. merchandise trade deficit has grown from $132 billion to $198 billion.(38) In that same period the number of Americans employed in manufacturing has grown from 18,075,000 to 18,678,000—an increase of more than 600,000.(39) If anything, rising trade deficits signal more jobs, not fewer.

Myth: “The Trade Deficit Is a Drag on Economic Growth”

The Asian financial crisis is expected to shave a few tenths of a percentage point off the rate of growth of U.S. GDP in 1998, but to blame slower U.S. growth on an expanded trade deficit is to confuse cause and effect.

The real drag on U.S. economic growth is falling demand in East Asia for U.S. exports. At the same time, falling currency values in East Asia make the region’s exports to the United States more attractive, leading to a larger U.S. trade deficit. A growing trade deficit is not the cause of slower U.S. growth; instead, slower growth and a bigger trade deficit are both effects of East Asia’s economic slowdown.

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![Graph showing the Trade Balance and Unemployment](image)
In his study, Morici claims that “persistent trade deficits reduce long-term economic growth by shifting labor and capital from high-R&D to low-R&D activities.” That claim is based partly on the fact that research and development expenditures, and wages, tend to be higher in trade-related (that is, exporting and import-competing) sectors than in non-trade-related sectors of the economy. The proper lesson to be drawn is not that trade deficits are bad for economic growth but that trade is good for growth. In other words, the true measure of the effect of trade on the economy is not exports minus imports but exports plus imports.

Far from being a drag, a trade deficit can be a good sign for an economy when it reflects growing demand for imports. When an economy expands, consumers are able to afford more goods, both domestic and imported. Returns on investment also increase, attracting foreign capital. The combination of inflowing capital and increased demand for imports tends to widen the trade deficit. That explains why every recent U.S. economic expansion has been accompanied by an expanding trade deficit.

Since 1980, in the six years in which the current account deficit has shrunk from the previous year as a percentage of GDP, the average growth rate of the U.S. economy has been 2.0 percent. In the 11 years in which the current account has grown larger as a percent of GDP (i.e. “worsened”), the average growth rate of GDP has been 3.1 percent. Those who maintain that the trade deficit is a drag on growth need to explain why our economy grows 50 percent faster in years in which the deficit expands.

Without a trade deficit, Americans would need to finance domestic investment exclusively from domestic savings. To bring investment in line with savings, domestic interest rates would need to rise, reducing investment and economic growth. As the Council of Economic Advisers recently concluded, the trade deficit has been a “safety valve” for the expanding U.S. economy. “Imports of goods have kept inflation low, while imports of capital have kept interest rates low, helping to sustain rapid income growth. In the strongly expanding full-employment economy that the United States now enjoys, it should be easier for Americans to see that trade deficits do not necessarily reduce output and employment.”

The United States ran trade deficits throughout much of the 19th century during a period of dynamic growth and expansion. From independence until the 1880s, America was a net importer of capital from the rest of the world, in particular Great Britain. Foreign investors provided the capital to build the railroads and canals America needed for a continentwide economy. “In the 19th century, especially after the cotton boom of the 1830s, it was the current account that went into the red in order to balance the heavy inflow of funds to finance American enterprise. The United States had more profitable investment opportunities than it had domestic savings to finance them. The British, Germans, Dutch, and French stepped in and made themselves (and our American forebears) richer.”

Today Americans run trade deficits with the rest of the world for much the same reason: America’s relatively free and unregulated economy offers attractive investment opportunities. Attempts to reduce the trade deficit through government intervention would reduce our economic efficiency, slowing investment and growth.

**Exports Are Good, Imports Are Better**

Underlying each of those myths, and much of the misunderstanding about trade deficits, is the assumption that exports are good and imports are bad. To anyone who accepts that premise, a trade deficit will by definition be a problem.

Pat Buchanan, during a 1996 campaign stop in Maryland, stated the case with characteristic bluntness: “This harbor in Baltimore is one of the biggest and busiest in the nation. There needs to be more American goods going out. We’ve got to start exporting more goods and stop exporting our factories and exporting our jobs.” Even many advocates of free trade implicitly agree with Buchanan. In his state of the union address in January, President Clinton urged Congress to pass fast-track trade legislation to “open more new markets” for U.S. exports and to “create more new jobs.” Imports, in contrast, were painted as a threat. The president warned that, without U.S. aid through the International Monetary Fund, falling currencies in the Far East would mean “the price of their goods will drop, flooding our market and others with much cheaper goods, which makes it a lot tougher for our people to compete.”

By focusing exclusively on the danger of “cheaper goods” and not the benefits, the president chose to champion the cause of a small group of producers while ignoring the welfare of the large majority of consumers who will benefit from more affordable imports.

Imports bless Americans in a number of substantial ways. First, imports mean lower prices and wider choice for American consumers. By exerting downward pressure on prices, imports raise the real wages of American workers. Imports create price
consumers. By exerting downward pressure on prices, imports raise the real wages of American workers. Imports create price competition where a domestic monopoly or oligopoly might otherwise exist. They also spur domestic producers to control costs and raise quality in response to foreign competition.

Second, imports of intermediary inputs benefit American producers by keeping final prices down. One reason the U.S. computer industry is so successful and competitive is that it is able to import component parts, such as disk drives and D-RAM chips, at world-market prices. The largest categories of goods imported to the United States are not consumer goods but capital goods and industrial supplies and materials. Together they comprised more than half of the $803 billion in goods Americans imported in 1996.(46) Restricting imports hurts unprotected producers as well as consumers.

Third, imports of capital goods make Americans more productive. Higher productivity means a higher standard of living. Without imports, Americans would be deprived of the technology and know-how embodied in new, imported machinery.

Exports are not the reason we trade; they are the means by which we acquire imports. It is imports, not exports, that allow Americans to enjoy a higher standard of living. Exports without imports are like a job without a paycheck.

Conclusion

Misunderstanding of the trade deficit threatens to undermine the freedom to trade by encouraging faulty and damaging “solutions” to a problem that does not exist. Any attempt to fix the trade deficit through protectionism, export subsidies, or currency manipulation is bound to fail because none of those tools of intervention addresses the underlying causes of the trade deficit. The trade deficit will respond only to changes in a nation’s net flow of foreign investment, which in turn is determined by its underlying rates of savings and investment.

America’s $114 billion trade deficit in 1997, and the prospect of a larger deficit in 1998, are not a cause for worry. Our trade deficit reflects the fact that America remains an attractive haven for international investors. The trade deficit allows Americans to maintain a level of investment in our future productivity that would be impossible if we were required to rely solely on our current level of domestic savings.

None of the common concerns about the trade deficit holds up to empirical scrutiny. Trade deficits cannot be blamed for unemployment or slower growth, nor are they a sign of unfair trade practices abroad or declining industrial competitiveness at home. Trade deficits may even signify growing consumer demand and expanding investment opportunities.

What matters to a nation’s economic health is not the difference between exports and imports but the degree to which its citizens are free to trade and invest across international borders. When citizens are allowed to buy and sell goods, services, and investment assets freely in the international marketplace, a nation’s productive resources will tend to flow to the best and highest use, raising the nation’s overall standard of living.

In the final analysis, nations do not trade with each other; people do. Every international transaction that Americans engage in will, by definition, leave both parties to the transaction believing they are better off than before—otherwise the transaction would not occur. By this measure, the “balance of trade” is always positive, benefiting the nation as a whole.

Notes


3. Transcript provided by the Media Research Center, Alexandria, Va.


8. Ibid., p. 269.


10. Duff.


15. Ibid.

16. In the official figures, the balance is not always zero. A government cannot keep track of every single international transaction its citizens engage in, as hard as its customs agents and financial regulators may try. That creates the need for a “Statistical Discrepancy” line in the accounts. In 1996 the statistical discrepancy in the U.S. balance of payments amounted to $46 billion. That may seem like a large amount, but it represents less than 1.5 percent of more than $3.1 trillion in total two-way transactions in 1996. For all practical purposes, the flow of money out of the United States in a given year equals the flow of money in.


19. Ibid., Table B-24, p. 308.


26. Moving to an investment-based, personally managed retirement system in place of Social Security might be one way to boost private savings.

27. The current account balance in 1991 received an additional boost of about $40 billion in the positive direction because of...
27. The current account balance in 1991 received an additional boost of about $40 billion in the positive direction because of transfer payments to the U.S. government from its Gulf War allies.


32. Ibid., Table B-103, p. 398.

33. Ibid., Table B-51, p. 340.


35. Ibid.


37. See Council of Economic Advisers, *Economic Report of the President 1998*, Table B-103, for the annual trade deficit figures and Table B-42 for the annual unemployment rates.


40. Ibid., p. 19.


Much Maligned Trade Gap. No economic statistic is reported more dolefully these days than the country's trade balance. Ever on the alert for signs of impending economic disaster, the press routinely couples reports of record monthly trade deficits with warnings of experts and Government officials of the dangers of the deficit. The trade deficit is a symptom of rising employment — not the cause of rising unemployment. That balance-of-trade figures are misunderstood and misused is not surprising, since their function has never been to inform or to enlighten. Their real purpose is to provide spurious statistical and pseudo-scientific support to groups seeking protectionist legislation.