Market Perspectives

Working Paper: Stop Worrying About the Trade Deficit

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Introduction

We've all been told deficits are bad. When headlines shout, "Trade Gap Widens!" or, "U.S. Trade Deficit at All Time High!" we cringe and worry. News stories, industry experts and government officials tell us to expect higher unemployment, slowing of economic growth and other economic horrors. Few stop to ask the question, "why?"

A trade deficit refers to the Current Account portion of the Balance of Payments. It is the total of all goods and services *exported* minus the total of all goods and services *imported*. If this difference is negative, it means that more goods and services were imported than were exported and it is called a deficit.

The graph titled "Balance on Goods and Services Trade" is from the U.S. Bureau of Economic Analysis (www.bea.gov) and shows that this deficit has been growing (getting more negative) for some time.

We expect our politicians to "do something," We ask them to erect trade barriers or negotiate agreements to make the trade more balanced. After all, we buy a lot from this or that country… it's only fair that they should buy more from us.

Let's consider these negative claims against a trade deficit and see what the facts have to say.

Some basic observations

If a trade deficit is bad, then a balanced trade account must be better – and a surplus must be the best. If we could find a country with a trade surplus, we would be able to test this claim.

There are many examples that tell pretty much the same story. Japan is one. Germany is another. Germany's trade surplus is €10-12 billion. It is the fifth largest economic power in the world and the largest in the European Union. It is also rapidly becoming the slowest growing. Economic growth over the period 2001-2003 was less than 1% (vs. 3% to 4% in the U.S.). Germans are struggling with unemployment (twice the size of U.S. unemployment) and have a large budget deficit (just like the U.S.).

There are many complex interactions within any country's economy. You should not infer that a trade surplus is the cause of high unemployment, low economic growth and debt burdens. In fact, because there are countries with trade surpluses – as opposed to the U.S.'s trade deficit – facing many similar problems, I am suggesting that a surplus or deficit in the balance of trade's current account is irrelevant.

The table titled "U.S. current account balance and economic performance, 1980-2003" refutes the

claims that a trade deficit is bad for economic growth, manufacturing or unemployment. You can find the research behind these numbers at www.freetrade.org (Center for Trade Policy Studies) in the report titled, "Bad News on Trade Deficit Often Means Good News on the Economy," by Dan Griswold, a Cato Institute research fellow.

The U.S. current account balance and economic performance, 1980–2003

	Current Account % GDP	Change from Previous Year in: C.A. % of GDP	Real GDP	Manu-facturing	Jobless Rate
When the Deficit Is "Improving":					
1988	-2.4%	1.0	4.1%	3.1%	-0.4
1991	-0.6%	0.7	-0.2%	1.0%	1.0
1989	-1.8%	0.6	3.5%	-1.3%	0.1
1990	-1.4%	0.5	1.9%	-0.8%	0.9
2001	-3.9%	0.3	0.5%	-5.3%	1.8
1995	-1.4%	0.2	2.5%	2.8%	0.1
1980	0.1%	0.1	0.0%	-1.2%	1.2
1981	0.2%	0.1	2.5%	-4.1%	1.3
Avg.	**-1.4%**	**0.4**	**1.9%**	**-0.7%**	**0.8**
When the Deficit Is "Worsening":					
1997	-1.5%	0.0	4.5%	8.9%	-0.7
1996	-1.5%	-0.1	3.7%	6.7%	-0.2
1987	-3.4%	-0.1	3.4%	7.3%	-0.9
1992	-0.8%	-0.1	3.3%	4.2%	0.1
2003	-4.9%	-0.3	3.0%	2.7%	-0.3
1982	-0.2%	-0.3	-1.9%	-5.0%	2.3
1985	-2.8%	-0.4	4.1%	1.0%	-0.3
1994	-1.7%	-0.4	4.0%	8.1%	-1.0
1993	-1.2%	-0.5	2.7%	4.1%	-0.9
1986	-3.3%	-0.5	3.5%	3.4%	-0.4
Avg.	**-2.1%**	**-0.3**	**3.0%**	**4.1%**	**-0.2**
When the Deficit Is "Rapidly Worsening":					
2002	-4.6%	-0.7	2.2%	0.8%	0.3
1998	-2.3%	-0.8	4.2%	4.8%	-0.3
1999	-3.1%	-0.8	4.5%	6.1%	-0.4
1983	-1.1%	-0.9	4.5%	13.0%	-2.5
2000	-4.2%	-1.1	3.7%	0.8%	-0.1
1984	-2.4%	-1.3	7.2%	6.4%	-1.0
Avg.	**-3.0%**	**-0.9**	**4.4%**	**5.3%**	**-0.7**

The data flout conventional thinking: On average, in years when the trade deficit shrinks (the "Improving" section of the table), manufacturing weakens, the jobless rate increases, and the Gross Domestic Product grows more slowly. Even more interestingly, the more rapidly the trade deficit grows (the "Worsening" and "Rapidly Worsening" sections of the table), on average, the better the numbers on GDP growth, manufacturing and employment.

It is probably not the case that a widening trade deficit *causes* improvement in an economy (anymore than a trade surplus is the cause of Germany's economic challenges). In fact, it is much more likely that the opposite is true – that is, that a widening trade deficit is a symptom of economic growth.

Capital Account: the other half of the story

Here is where the plot thickens: the current account within the balance of trade is only *half* of the story. To understand why, consider a simple transaction: Mr. Smith, a consumer in Wichita buys a car from Ms. Nissan, a producer residing in Tokyo, for 25,000 U.S. dollars.

The U.S. government, in tracking this transaction, places into the current account an entry on the import side of $25,000. The U.S. now runs an additional $25,000 trade deficit with Japan. That seems simple enough.

But wait… that was only one half of the transaction. What happened to the $25,000 in cash that Ms. Nissan received for her car? We record that in the c*apital account*.

Where the current account is the sum of all exports minus the sum of all imports, the *capital* account is the sum of all cash accounts, corporate bonds, equity, real estate and other purchases – including government debt instruments like savings bonds and treasury bills. By definition, the difference between the *capital* account and the *current* account must equal zero.

That is the arithmetic way of saying the obvious: that the Balance of Payments always balances. In our example, Mr. Smith's car is "debited" from the current account, while the $25,000 in cash given to Ms. Nissan in exchange is "credited" to the capital account.

Trade is vital to our economy

If you've ever played our "Exchange Game" in MBM® Academy, you've experienced how trade creates wealth through voluntary exchange. Existing goods and services are continually rearranged into new higher-valued patterns as subjectively determined by the participants. Fundamental to voluntary exchange is the principle that each side will only transact when there is an expected benefit.

Using this perspective, the terms deficit and surplus are nonsense when attached to trade. Lines on a map don't change the principle that both sides of a trade gain from the exchange. You don't think of yourself as having a trade deficit with your dentist. Nevertheless, you buy more products and services from him than he does from you… so why aren't you more concerned? Does it make sense to ask a court to force the dentist to buy services from you? So why should things change if your dentist resides in Quebec City, Canada instead of your hometown across the border of Presque Isle, Maine?

The U.S. doesn't trade with France. Germany doesn't trade with Japan. Individuals trade with individuals. It is mutually beneficial. They *both* gain.

And what of Ms. Nissan's $25,000 in our example, which Mr. Smith recently paid for his car? She has choices. She can leave it in the bank – and the bank can loan it out for productive use by other Americans (to buy cars, houses, create new business ventures). She can invest it herself in corporate equities and debt. She can buy other products or services, or invest in real estate. She might even buy government debt – treasury bills or savings bonds.

If someone shows up at your door wanting to buy your products or services, buy equity in your firm, loan you money – that's a very positive thing. People don't buy equity or loan capital to entities that are perceived to be on the skids. They aren't eager to buy shoddy products or services. They invest in things they expect to get a return from – in entities that are strong and productive.

The Debt Issue

The fact that Ms. Nissan can buy debt has many people up in arms. With a sneer they say the U.S. is a debtor nation and suggest it is the foreign lenders' fault for loaning money to us. At the same time, they cast moral aspersions on the character of the country ("neither a borrower nor a lender be"). Among the more extreme voices, there are even concerns that foreigners will foreclose on us and ruin our country.

There are at least three problems with this point of view. First, the U.S. doesn't collectively borrow money. Individuals do – for themselves or as representatives of corporations or government entities. Second, it ignores what the loan is being used for. Most people borrow money to achieve some productive goal – and believe they can use that capital for a purpose that is valued to be higher than the cost of borrowing it. And third, lenders don't foreclose on responsible borrowers who are keeping up their payments.

And most *are* responsible – some are not, but most are. Governments are perhaps the least likely to have the incentive to utilize discipline in borrowing, in which case our concern is with government borrowing practices, not the allocation of capital account items in the balance of payments. Even so, loans themselves are not the issue – it's what they are used for that should concern us. Borrowed money put to productive use makes sense – it is a trade across time where both lender and loaner benefit (otherwise they wouldn't transact). Like much in life, it's not what, it's <u>how</u>.

Conclusion

Hand wringing over the "trade deficit" is perplexing. We've seen data showing that a so-called "worsening deficit" turns out to have positive economic data associated with it – and conceptually

it doesn't even make sense. We know how trade works – people only exchange when both sides expect to gain. It is hard to reconcile the terms surplus and deficit when both sides benefit – especially when the *balance* of trade *balances* perfectly once we correctly account for the entire economic value (the current *and* capital accounts).

There are other arguments against trade deficits that have not been considered. They typically reflect the fact that the global economy is a complex interconnected system. Often these arguments are a proxy for some other real issue, like the budget deficit, currency devaluation, inflation, etc.

This brings me to a final point. The economics presented above are sound, but the world is necessarily less straightforward than one might project from these basic ideas. I hope that you are more curious about this issue than when you began reading. In that regard, I've listed below several web resources for those interested in taking their understanding to another level in addition to the texts.

If someone offers you an argument for why trade deficits are bad, I hope you will listen with a new perspective. Be open minded and always be willing to be wrong – but use critical thinking and don't toss out the mental models you've got for understanding how trade works.

For Discussion

In his book, Economic Fallacies Exposed, Geoffrey Wood, a professor of City University Business School in London, England, said, "a current account deficit – more goods and services being bought from abroad than are sold here – is not itself a problem. It implies foreign borrowing. What matters is not the borrowing, but what has produced it and what it is being spent on. Current account imbalances are symptoms – but they can be symptoms of sensible decisions or folly." Use this as context for discussion with a group. Is it ever legitimate to live beyond your means as an individual, family, business, country? When? Why or Why not?

Further Reading Suggestions

The Economic Way of Thinking, Heyne, Tenth Edition

The Balance of Trade, Bastiat, (http://www.econlib.org/library/Bastiat/basEss13.html#Chapter 13)

Trade Deficit, Reed (http://www.fee.org/vnews.php?nid=4188)

Cursed by Economic Knowledge, Boudreaux (http://www.fee.org/vnews.php?nid=4034)

Balance of Payments, Stein (http://www.econlib.org/library/Enc/BalanceofPayments.html)

America's Maligned and Misunderstood Trade Deficit, Griswold (http://www.freetrade.org/pubs/pas/tpa-002.html)

Foreign Trade Statistics, US Census Bureau (http://www.census.gov/indicator/www/ustrade.html)