

# When Bad News Is Good

## Exploring the Trade Deficit Myth

By Tod Ginnis

Maybe it's inevitable. When the economy heads south, nations turn inward. Populist pundits and politicians whip us into a frenzy about keeping precious jobs at home. Our trade deficit, they say, will eventually drag the U.S. to third world status. How could any patriotic American oppose reducing this massive gap?

Of all the misconceptions in economics, the fear of trade deficits may be the most widely held. It leads to self-destructive policy decisions supported by people of every income level, as well as many companies. Politicians left and right jump on board.

### What is a trade deficit?

The concept of a deficit is straightforward: you spend more than you take in. This holds whether we are talking about a person, a company, or a government. But when discussing trade, just who is the "you"?

Economists estimate the value of all goods and services produced in one country and sold in another. Countries whose resident firms export more than its own citizens, companies, and governments import (like China) run a trade "surplus;" those that collectively import more than they export (like the U.S.) are labeled "deficit" countries.

Right off the bat I can think of a couple of problems with this method. First, is the number accurate? When dealing with government statistics, the answer is likely NO. For many years, the U.S. government measured software by shipping weight. That's impossible now, as firms have nearly abandoned physical software in favor of digital distribution. But you can always count on bureaucrats to crank out complicated figures to justify their employment. No doubt trade reports are full of them.

Second, is the trade number meaningful? Countries don't trade with each other: American consumers, businesses, and governments buy things from foreign producers. Meanwhile, while foreign consumers, businesses, and governments buy other things from U.S. producers. No one has demonstrated why adding up all these numbers makes any sense.

Sometimes trade numbers are just plain bogus. In the 1980s, U.S. policy makers used creative accounting to claim Japanese manufacturers were selling goods below cost. Here's one scam detailed in James Bovard's 1992 book "The Fair Trade Fraud": most American corporations had layers of bureaucracy their Japanese counterparts did not. This added expense made it extremely difficult for the Americans to compete on a level playing field. So the government tilted the field. The International Trade Commission (ITC) added a phantom amount (say 20%) to the Japanese firm's costs to estimate what its cost of production would be if it were an inefficient American firm. The resultant (fantasy) number "proved" the company was selling at a loss—sometimes of a fraction of a penny—to drive out U.S. competition. Often the ITC penalized such companies with severe tariffs.

### Trade deficit shrinks as economy tanks

According to a March 16, 2006 Wall Street Journal editorial "Trade Deficit Disorder," since the mid-1980s "the trade deficit has risen when the economy has grown and receded when the economy has faltered. The lowest annual U.S. trade deficit in recent times was recorded in 1991, a recession year." Indeed, the U.S. ran trade surpluses all but one year of the 1930s. For those who aren't history buffs, many call that era "The Great Depression."

The Cato Institute's Dan Griswold discovered "there is a strong correlation between rising trade deficits and falling unemployment." Does the reverse hold? You betcha! The December 2008 U.S. trade gap shrank to its lowest level in nearly six years, down more than 30% from the previous December. Yet in spite of these improving trade numbers, nobody seems to be in a partying mood. Once again, it took a recession to take a bite of our trade deficit. Given the choice, I'll stick with growth.

In 1976, a group of prominent economists (the U.S. Advisory Committee on the Presentation of Balance of Payment Statistics) urged that we drop words such as "surplus" and "deficit" when talking about trade. "These words are frequently taken to mean that the developments are 'good' or 'bad' respectively. Since that interpretation is often incorrect, the terms may be widely misunderstood and used in lieu of analysis." Amen.

### What about all those dollars going overseas?

Some argue that a trade deficit causes dollars to flow out of the U.S. economy. Initially that's true. But most dollars come back to the US in some form of investment. This is a good thing, as this investment helps spur economic growth (equity and direct investment), or puts downward pressure on interest rates (bonds).

The dollars that remain overseas merely act as stores of value, or theoretical debts that the US doesn't pay interest on. Much of that money will never return to the U.S., which is the equivalent of the post office issuing stamps to collectors. The USPS takes in money, but doesn't provide any services in exchange for that money. Pretty good deal.

Economics guru Milton Friedman said foreigners keeping dollars overseas yields the same result from our perspective as if the exporting countries burned their dollars. Friedman believed many of those stoking fear of trade deficits over the years were touting policy solutions that helped exporting firms. While protectionism is bad for most consumers and producers, there is no doubt it can be a bonanza for some businesses.

Economy theory is fine. But what happens in the real world? Does a wide trade deficit really hurt the economy? Investor's Business Daily tackled this subject in a January 14, 2009 editorial

“Trade Gap Plunges; Feel Better Now?” It noted from the end of the recession in 2001 through 2006, a period of strong economic growth in the U.S., the trade deficit surged to record levels. But as Encima Global economist David Malpass reported, during that time the U.S. created 9.3 million jobs. Japan’s huge trade surplus helped it add just 360,000 new jobs, and “Europe — excluding Spain — created just 1.1 million. (Like the U.S., Spain ran big deficits. It created 3.6 million new jobs — more than three times the rest of the Euro zone combined.)”

### What’s a government to do?

If a nation decides to influence trade, there are really only two ways to do it:

1. By law—using tariffs and quotas, which add taxes or limitations to imported products. The hoped for result is that domestic alternatives will be more attractive to consumers.
2. By trying to alter its currency’s value—a weaker currency will make a country’s exports cheaper to foreigners, and make imports more expensive for its own consumers.

Protectionists argue that if we didn’t have the option to buy foreign products—or they were more expensive—then more consumers would choose American-made competitors. This, they say, would be a boon to US employment.

### Protect me from low prices!

There is no free lunch. “Protecting” US industry from cheap foreign goods forces American citizens to pay more for these products. Higher import prices affect consumers directly, as well as indirectly (higher prices on imported steel raise the price consumers pay for products containing steel). Tariffs and quotas don’t just raise the price of imported items—they allow domestic producers to raise their prices.

Economists estimate the voluntary import quotas of the 1980s allowed U.S. carmakers to charge on average an additional \$400 for every car. Meanwhile, scarcity pushed the price of Japanese cars \$1000 higher. I wonder if consumers would support such policies if they realized it was coming out of their pockets. And what about all the consumers relegated to buying used cars because they couldn’t afford the extra grand? Tariffs and quotas are merely a transfer of wealth from consumers to certain favored industries. If you think that’s a good idea, let’s at least have an honest debate.

So protectionism forces some Americans to subsidize others. All consumers and businesses pay this de facto tax. Removing or reducing tariffs and quotas would be equivalent to a tax cut. How many new jobs would emerge from the growth that normally follows large tax cuts? Would it exceed the number lost to cheap overseas competitors?

To answer this intelligently you must calculate how much a subsidy costs consumers and businesses, and how much the policy is worth to the beneficiaries. For example, what rational taxpayer would support spending \$200K of our money to save a \$50K/year job? Unfortunately,

those supporting protectionist policy rarely do this calculation...or don't do it accurately. The result would likely demonstrate the folly of their policy prescription. But most politicians and lobbyists aren't interested in doing what's best for taxpayers.

Sometimes the damage caused by protectionism is not obvious. Let's look at the candy industry. To protect U.S. sugar producers, there are strict quotas and heavy tariffs on sugar sold in the U.S. Food manufacturers that use a lot of sugar pass these added costs on to consumers. But candy manufacturers use so much sugar that some have found it impossible to do business in the U.S. Many have crossed the border into Canada over the years, taking their jobs with them. There they can buy sugar at the sharply discounted rate the rest of the world pays. American sugar producers benefit from the subsidy. But is the benefit to a few sugar conglomerates worth the loss of jobs and higher prices paid by American consumers?

#### The Smoot-Hawley smack down

Many economists believe America's Smoot-Hawley tariffs of the early 1930s helped turn an economic contraction into the Great Depression. U.S. imports from Europe declined from a 1929 high of \$1.33 billion to just \$390 million in 1932, while U.S. exports to Europe fell from \$2.341 billion in 1929 to \$784 million in 1932. World trade fell by more than 50% between 1929 and 1932. Regardless of who had a surplus and who was in deficit, these were horrible figures for everyone.

You can argue about the impact of Smoot-Hawley. The new tariff rates were not the highest the country had seen. Perhaps a sudden jump in tariffs at the wrong time is what drove the world into the Great Depression. Maybe the long debate before the tariffs passed caused businesses to turn inward. Or maybe Smoot-Hawley was benign legislation that just happened to pass as the economy cratered. It is interesting that protectionist laws never seem to lead to prosperity.

#### Protectionism on the rise

Here are a few recent examples of protectionism from around the world:

- On 2/16/09, Indonesia's government announced plans to require civil servants to "buy local," that will include penalties for non-compliance. The rules, which went into effect in March, include the purchase of food, drinks, shoes, clothes, accessories, music, and films. Indonesia wants to boost domestic demand and combat the effects of the global financial crisis. (Note: I'm considering moving to Bali to make my fortune selling black market Big Macs to hungry government employees).
- On 2/17/09, Henri Guiano, Sr. Aide to President Nicolas Sarkozy, told Le Monde that France needed rules on industry protection and government intervention to prevent political and xenophobic protests. He fears a repeat of December's Greek riots. Sarkozy has made similar comments publicly.
- On March 2, 2009 Paraguay revealed plans to institute temporary protectionist measures to combat similar policies it said Brazil and Argentina have adopted.

Paraguayan Treasury Minister Dionisio Borda said the government would unveil a “buy national” campaign by the end of the week in an effort to offset the effects of the global financial crisis.

- There were “buy American” provisions all over the economic “stimulus” package enacted in February 2008.

#### Something to chew on

I won't try to prove the exact impact of deficits and trade wars. The multiple factors involved make it very complicated and well beyond the scope of this article. Anyone with a basic understanding of statistics will tell you correlation does not equal causality. But here's something to chew on: politicians and pundits tell us to accept on faith that trade deficits are damaging America. Since our economy seems to expand while in deficit, and contract while in surplus (or when the deficit gets smaller), don't you think we should at least challenge them to prove their case?

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