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WHEN TRADE DEFICITS ARE NOT A DANGER SIGNAL

The Commerce Department reports that the U.S. current account deficit hit a record $89.9 billion in the third quarter. That is up $9 billion from the second quarter and $26 billion above the third quarter a year ago. Critics of free-trade policies, emboldened by their success is disrupting the World Trade Organization (WTO) meeting in Seattle, have seized on these figures as evidence that America should restrict its trade policies. James Hoffa, President of the Teamsters Union, declared, "A trade deficit like that threatens jobs in the U.S." (*Wall Street Journal*, Dec. 15, 1999.)

If current account deficits cost jobs, nations with large deficits should have meager job creation and high unemployment... Yet, the United States, with its record trade and current account deficits, now has a jobless rate of only 4.1%, its lowest in 30 years. Since 1982, the U.S. economy, while registering a current account deficit in every year but one, has generated over 30 million added jobs.

International comparisons, however, contradict this scare scenario. If current account deficits cost jobs, nations with large deficits should have meager job creation and high unemployment, while nations with big surpluses should have rising employment and low unemployment rates. Yet, the United States, with its record trade and current account deficits, now has a jobless rate of only 4.1%, its lowest in 30 years. Since 1982, the U.S. economy, while registering a current account deficit in every year but one, has generated over 30 million added jobs. On the other hand, France and Italy had current account surpluses in 1997 of $39.5 billion and $33.4 billion, respectively, but jobless rates of 12.4% and 12.1%.

In recent years, the nation with the largest trade surpluses has been Japan. In 1997, its current account surplus was $94.4 billion. Nonetheless, Japan has been mired in a slump for most of the 1990s, and, in the latest quarter, its GDP was contracting. Japan's difficulty is not its trade surplus, which, by itself, is neither good nor bad, but a series of unwise economic policies it has embraced, including 1988 and 1990 tax "reforms" that increased tax biases against saving and investing, bloated public works outlays, and rejection of market and regulatory reforms that would have facilitated more efficient use of resources. Last years's tax changes may lead to some improvement, but over-spending remains a problem.

Countries can have current account deficits for a variety of reasons. One reason is a strong economy, such as that of the United States. A country's current account often moves towards deficit when the country is growing faster than its trading partners because its growth raises demand for imports. Conversely, the current account often moves towards surplus during downturns when demand for imports weakens. The last U.S. current account surplus was during the recession year of 1991, and before that, in the recession year of 1981. A recession would improve the U.S. current account, but would hurt U.S. employment.

Another reason for the current account deficit of the United States is capital inflows. The United States attracts capital from abroad because it offers good investment opportunities. It is politically stable and has a relatively benign tax and regulatory

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climate. The U.S. tax system, although complex and biased against saving and investment, improved dramatically in the early 1980s and is better than the tax systems in most nations. Government regulation, while excessive in the U.S., is even worse in many other countries.

> ***[A] current account deficit is ... not automatically bad or a sign of trouble. Sometimes, it is the result of beneficial economic policies and a strong economy.***

To purchase capital in the United States, foreigners need U.S. dollars. One way foreigners can obtain the dollars is to sell additional merchandise in the United States (U.S. imports) and use the revenues to buy capital in the U.S. That gives the sellers of the U.S. capital additional foreign currency to spend abroad. The rise in imports then widens the U.S. current account deficit.

The capital inflow effect may have been most striking during the 1980s: the current account deficit grew rapidly due to significant improvements in U.S. tax and regulatory policies and a sharp reduction in U.S. inflation (which encouraged U.S. capital to remain at home and attracted foreign capital) coupled with turbulence in a number of foreign countries to which U.S. banks and other investors had been lending (which also reduced U.S. lending abroad and encouraged foreign capital to move to the U.S.)

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The rise in capital inflows and imports has helped, not hurt, Americans. It has allowed Americans to maintain consumption while boosting investment in the United States. The added investment raises worker productivity and wages. American workers capture about half of the extra GDP produced by added capital investment. Federal, state, and local governments take over 35% in tax. The foreign investors capture around 15%. The U.S. receives the majority of the gains!

A special factor for the United States is the role of the U.S. dollar as a reserve currency. Foreigners are often willing to trade their goods and services without demanding U.S. goods and services in return; they keep the U.S. dollars. In effect, dollar balances become an "export". With less current production taken by foreigners, more remains at home for the enjoyment of Americans. The only negative in this is that if the United States were to adopt unsound monetary policies in the future, foreigners might lose confidence in the dollar and try to exchange their dollars for U.S. output, which would reduce the output remaining for Americans. But the source of this problem would be bad monetary policy, not the current account deficit, and the way to avoid the problem is to maintain a prudent monetary policy.

The argument here is not that a current account deficit is necessarily good but that it is not automatically bad or a sign of trouble. Sometimes, it is the result of beneficial economic policies and a strong economy.

Much of the opposition to international trade arises because, in addition to many winners, some businesses and workers do lose with trade, and their loses are frequently easy to see and anticipate. For instance, high-wage, semi-skilled union workers often regard trade as a threat to their jobs. Although international trade also creates jobs, those who obtain the new positions frequently do not know it in advance and, even then, may not recognize the link between trade and their jobs.

There are enormous advantages from trade. One of the biggest is the boost it gives to economy-wide productivity. When people can trade, each

tends to do what he or she does best. The increase in output lifts incomes and enables people, in general, to be better off. Some businesses and workers are hurt when protectionist barriers come down, but the country gains. If trade were bad, then the most autarkic (self-sufficient) and isolated countries, such as North Korea, or South Africa during apartheid, and countries under trade embargoes, such as Iraq and Cuba, would be the most prosperous.

Trade boosts productivity. Suppose the United States required that all bananas consumed in this country be produced here, notwithstanding the difficulty of commercially growing bananas in the U.S. climate. Employment would increase for domestic banana growers. Productivity would fall, however, as people shifted from jobs at which they had been relatively efficient to the inefficient task of growing bananas in the United States. Living standards would decline and the general public would be hurt because bananas would become scarcer and more expensive without access to inexpensive foreign supplies and, in addition, because supplies of other goods and services would shrink as domestic production shifted from them to banana growing.

International trade is not a zero-sum game in which nations with trade surpluses win while countries with trade deficits lose. Contrary to the protestors in Seattle and other advocates of protectionism, trade is a positive-sum game that benefits all nations, including those with large deficits that are the result of sound domestic policies.

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