The Trade Deficit is Meaningless

US News, 04/04/17

https://www.usnews.com/opinion/economic-intelligence/articles/2017-04-04/dont-buy-into-donald-trumps-fearmongering-over-the-trade-deficit

American politicians have long complained of trade deficits the United States has with foreign nations. China is only the most recent case in point. But from the perspective of President Trump, it is a near-perfect case in point. Last year, Americans bought around $450 billion worth of goods from China, while the Chinese bought only $100 billion worth of goods from Americans, resulting in a trade deficit of some $350 billion. But here's the rub: A trade deficit is largely meaningless. Consider two things.

First, the trade balance between the US and individual countries is utterly meaningless. For example, if the US buys $100 worth of goods from China, China buys $100 worth of goods from Germany, and Germany buys $100 worth of goods from the US, then the US trade balance is zero despite the fact that the US has a trade deficit with China. To the extent that trade deficits matter, if they matter at all, they only matter in the aggregate, not with respect to individual countries.

Second, even in the aggregate, trade deficits are largely meaningless. And here, the word "deficit" is misleading. For example, we know that government budget deficits are harmful because they mean that the government is spending more than it collects in taxes. But this is not what "deficit" means in the context of trade. If the US has a trade deficit (in the aggregate), it means that Americans have bought more goods and services from foreigners than foreigners have bought from Americans. And this gives rise to a false image of dollars flying out of the US never to return. But every dollar of trade deficit is counterbalanced by a dollar of capital surplus. In this context, "capital surplus" means that foreigners have bought more financial assets from Americans than Americans have bought from foreigners..

In short, when the US has a trade deficit (and, consequently, a capital surplus) it simply means that Americans have paid for foreign-made goods and services by selling US-made financial assets - typically stocks and bonds - rather than by selling US-made goods and services.

The less naive (though still wrong) view is that this is bad because it means that eventually foreigners will own all the American companies. That's as foolish as saying that, because of the trade deficit, Americans will end up owning all of the Chinese steel. Just as China can make more steel, Americans can make more companies.

And this is where things get interesting. Countries export the things they are particularly good at producing. The Chinese are good at producing steel. Middle Eastern nations are good at producing oil. South Africa is good at producing precious minerals and metals. Mexico is good at producing textiles. And Americans? Americans are good at a number of things - among them, entrepreneurship. And while it's not possible to export entrepreneurship, it is possible to export the fruits of entrepreneurship. That's exactly what those American stocks and bonds represent. When the US incurs a trade deficit, it is purchasing foreign goods and paying for them with capital created by American entrepreneurs.

The US manufacturing industry has somehow became the poster child for all kinds of bad trade myths. The story goes that US manufacturing has been in decline for decades because Americans can't compete with cheaper foreign imports. For evidence, protectionists point to plummeting jobs numbers. In 1987, more than 17 million Americans worked in manufacturing. Today, that number is just over 12 million. In 30 years, the US lost one-third of its manufacturing jobs. But the number of jobs is the wrong metric. The correct metric is the output per job. And there, we see an entirely different story. Since 1987, US manufacturing output has almost doubled. That means that the average American manufacturing worker today is producing two-and-a-half times the output that the average American worker produced just thirty years ago. That's not an industry in decline. It's an industry that is going gangbusters.

But the politicians will report this as a failure, and a dangerous failure at that, because they have to. Politicians trade in fear, not prosperity. And as long as they can keep the voters frightened of disappearing jobs, politicians will always be in business. All they have to do is to attach disappearing jobs to an international villain, not to the normal processes of efficiency gains that we have experienced as a rule since the dawn of American industry.

But all of this overlooks fully half of the trade transaction in the first place. The simple fact is that Americans are buying things from foreign concerns, and for every dollar that flows out of the country, a dollar's worth of goods and services flows in. Americans are, in short, getting what they pay for. And when they get a better deal in international markets, that's where they spend their dollars. It has ever been so.

And that is why trade deficits are meaningless in the grand scheme of things. Americans pay dollars and get things. By the same logic, one would have to conclude that people have trade deficits literally everywhere they make a purchase of any kind, from the local butcher to the barbershop, but people get meat and haircuts. Transactions are all there is, and as long as people strike deals they think to be favorable, there are no losers to speak of.

In the end, the United States cannot compete with China, for example, on labor costs. So it doesn't. China cannot compete with the United States on a number of other fronts, like entrepreneurship and engineering, to name but two. So it doesn't. Instead, they trade. Trade overcomes deficits, it does not cause them. As such, it should always be encouraged, fostered, and depoliticized. But that's a foreign concept to the politicians among us, because you cannot buy votes with that.