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THE MYTHS AND REALITIES OF TRADE DEFICITS

INTRODUCTION

The Clinton Administration's near collision with Japan over automobiles and auto parts almost started a trade war with America's second largest trading partner. Fortunately, however, the Clinton Adminstration backed off from insisting on numerical targets in the trade agreement, even though numerical purchasing quotas were the heart of its position. Thus, what was largely a defeat for Clinton's managed trade policy is a victory for the American consumer.

But the President and his trade team may not have learned the larger lesson from their defeat. Underlying the Clinton Administration's policies toward Japan is an irrational fear of trade deficits and the belief that protectionist policies are necessary to combat them.

Concern that Japan is trading unfairly with the U.S. motivates many within the Clinton Administration (and in Congress) to strive for what they call a "balanced trade sheet." Specifically worrisome is the U.S. trade deficit with Japan, which is now about $50 billion a year.[1] The belief that trade deficits are harmful is what drove the Clinton Administration to threaten Japan with a trade war over automobiles and auto parts.

The Clinton Administration's managed trade policies are based on a number of faulty assumptions and myths about trade deficits. Specifically:

❶ **That trade deficits are harmful and trade surpluses are beneficial;**

❷ **That trade deficits cost jobs;**

1 It is commonly reported the U.S. had a $66 billion trade deficit with Japan in 1994. This is not true. In fact, the U.S. had a $16 billion trade surplus with Japan in services in 1994. Thus, the overall trade deficit with Japan is only $50 billion.

❸ **That Japan's prosperity is based on trade surpluses generated by managed trade policies;**

❹ **That American companies will go bankrupt unless the U.S. government limits import competition and forces foreign countries to purchase more U.S. goods;**

❺ **That because the U.S. is unable to sell some goods and services there, Japan's market must be closed;**

❻ **That trade surpluses are always the result of government policy;**

❼ **That trade retaliation is the most effective way to eliminate trade deficits; and**

❽ **That trade sanctions to redress imbalances will protect American jobs.**

In each case, however, the answer is: Not true. For example, the U.S. has run a trade deficit for most of its history, even during periods of economic growth, and the record shows that unemployment generally drops as trade deficits rise. Moreover, managed trade lowers living standards. The Japanese consumer is 30 percent to 40 percent behind his American counterpart in terms of real purchasing power.

In addition, protectionism may save jobs in one industry, but it often destroys many more jobs in other industries. The fact is that, in most cases, trade retaliation has failed to open markets while costing American consumers billions in higher prices. And yet, the myths persist.

THE MYTHS OF MANAGED TRADE

The Clinton Administration's approach to settling its trade disputes with Japan, China, and other countries rests on a number of myths and faulty assumptions about trade deficits. These myths are the intellectual foundation of the Administration's managed trade policies.

MYTH #1: Trade deficits are harmful and trade surpluses are beneficial. This is the core idea of protectionism and managed trade policies. Advocates of this point of view argue that trade deficits harm the economy, destroy jobs, and reflect a weakness in the economy.

REALITY: Not true. Trade deficits are more a sign of strength than of weakness. The meaning of the U.S. trade deficit is that Americans hold more goods than their foreign trading partners, while foreigners hold more U.S. dollars. This is a sign of America's wealth. Being the richest country in the world, America consumes goods and services from both U.S. and foreign companies. The influx of foreign goods and services in return for dollars adds to America's wealth. It does not detract from it.

Americans receive imported goods and services that increase their standard of living. Moreover, the dollars sent abroad for the purchase of goods and services typically cannot be used within those countries. While the dollars are traded between countries in the financial markets, they are used mainly by foreign consumers to buy American goods and services. Thus, nations use surplus dollars to buy American goods and services, invest in U.S. firms, or purchase U.S. Treasury bonds. These investments create jobs and wealth for Americans, while the purchase of Treasury bonds frees U.S. domestic capital for savings, investment, and purchases.

Consider the following example: The way the protectionists see it, most people run a trade "deficit" with their grocer. When someone goes to the supermarket and buys $150 worth of groceries, the protectionist believes the proprietor has a trade "surplus" of $150, while the customer has a "deficit" of $150. But this is not the case at all. The grocer ends up with $150 in currency, while the customer has $150 worth of groceries. It is a mutually beneficial transaction. Thus, both the grocer and the customer are winners. There are no losers. No one would expect the grocer to buy an equal amount of goods from the customer in order to have an equal balance sheet in exchanged goods. Nor should one expect countries to have an even balance sheet in international trade. The trade deficit represents nothing more than a surplus of foreign goods and services which Americans now own. The value of these goods and services is as much a part of the national wealth as is possession of U.S. dollars.

Another misunderstanding involves trade deficit figures. At least one-third to one-half of the U.S. trade deficit figure counts U.S. imports from American overseas subsidiaries as part of the deficit. For example, when Ford Mexico sends a motor from its plant to the Ford assembly plant in Detroit, it is counted as an import. However, if Ford then sells an American-made car with a Mexican-made motor in the U.S., there is no corresponding export. Thus, a "deficit" supposedly is created. But why should a car sold in the U.S. be calculated as part of the trade deficit? Most of the money made from this sale stays in the U.S.

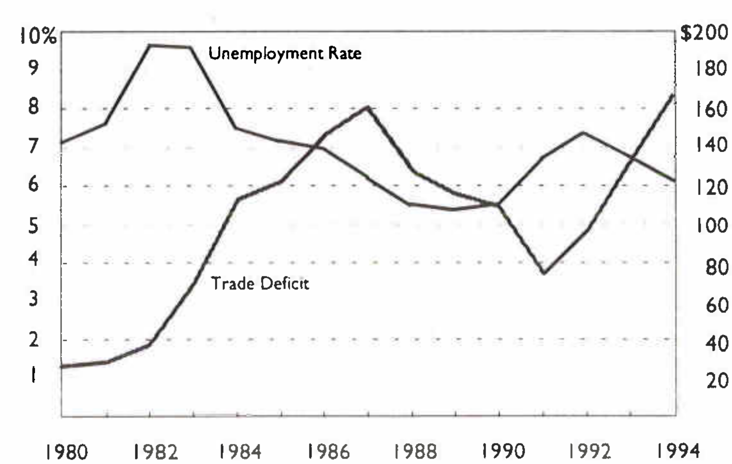
Trade deficits are not harmful to the economy. If they were, America would not be the economic powerhouse it is today. For most of its history, the U.S. has run a trade deficit. For the first hundred years, these deficits were fairly large. Nevertheless, throughout this period, growth rates were higher than they are today. Trade deficits did not destroy the economy then. Nor will they destroy it in the future.

MYTH #2: Trade deficits cost jobs. Protectionists claim that trade deficits are a major cause of unemployment. This is the assumption that animated Ross Perot's charge that the North American Free Trade Agreement (NAFTA) would cause a "giant sucking sound" of jobs heading south to Mexico.

REALITY: Not true. History shows that, on average, unemployment drops as trade deficits rise. If this myth were true, unemployment rates would go up when trade deficits grow, and unemployment would drop when they shrink. In fact, the opposite

Chart 1

U.S. Unemployment Rate and Trade Deficits: 1980-1994



Source: Office of Management and Budget, *Economic Report of the President*, 1993, 1994, 1995.

is more likely. For example, while the trade deficit leaped in 1983-1984 and peaked in 1987, the U.S. unemployment rate plummeted, falling from 9.6 percent in 1983 to 5.5 percent in 1988; when it began to shrink from 1989 to 1991, unemployment rose from 5.3 percent to 6.7 percent. When the trade deficit began to rise from 1992 to 1994, unemployment shrank from 7.4 percent to 6.1 percent (see chart).

Looking further back in history only confirms that trade deficits do not cause a loss of jobs. Every year the trade deficit increased since 1962, unemployment decreased. Likewise, every year the trade deficit decreased since 1962, unemployment increased.[2] Despite the trade deficit, the economy was growing and jobs were being created.

MYTH #3: Japan's prosperity is based on trade surpluses generated by managed trade policies. U.S. policymakers often use Japan as an example of how a country can eliminate trade deficits by managing trade and industry.

REALITY: Not true. A closer look reveals that Japan's managed trade policies have had mixed results. In fact, too much government "management" may be responsible for Japan's current economic malaise. If the people's standard of living is the measure of success, Japan has lost the "economic war" with the U.S. For example, the real purchasing power of Japanese consumers is 30 percent to 40 percent lower than that of the American consumer. Thus, in purchasing power terms, the Japanese are at least one-third poorer than Americans.

Japan's lower standard of living can be attributed partly to managed trade and industrial policies that drive up the cost of living. For example, policies that restrict such imports as agricultural products, beef, and other food items force the average Japanese to spend about 25 percent of his disposable income on food, compared to less than 12 percent for Americans. Spending more on food means less money for housing and other needs. The result: a lower standard of living.

MYTH #4: American companies will go bankrupt unless the U.S. government limits import competition and forces foreign countries to purchase more U.S. goods. Advocates of managed trade argue that closed overseas markets are the chief reason for America's trade deficit, causing enormous economic hardships that result in bankruptcies and lost jobs.

REALITY: Not true. This scare tactic is employed by U.S. companies to frighten policymakers into taking up their cause in Washington. And what is their cause? To limit import competition with trade protectionism and force foreign countries to purchase a set amount of U.S. goods and services. These companies argue that they are hurt by closed markets overseas. As a result, they want Congress and the Administration to punish American consumers by forcing them to pay higher prices for imported products like automobiles.

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2 Based on "Economic Report of the President," The White House, 1993, 1994, 1995 editions.

But if American companies are so beset by closed markets overseas, why is America the world's largest exporter? The U.S. exported over $697 billion in goods and services in 1994.[3] By contrast, Germany exported only $607 billion and Japan only $395 billion.[4] Clearly, most U.S. exporters find overseas markets for their goods.

The most vocal complainer is the U.S. automobile industry. Ford Motor Company, General Motors Company, and Chrysler Corporation are at the forefront in lobbying the U.S. government to pressure the Japanese government to open its markets to American cars. But the Big Three earned $14 billion in profits last year. They are in no danger of bankruptcy; nor do they deserve government coddling.

MYTH #5: Because the U.S. is unable to sell some goods and services there, Japan's market must be closed. Many trade deficit "hawks" argue that the U.S. has an open market, while Japan restricts American imports. Thus, Japanese protectionism supposedly is the main cause of the U.S. trade deficit with Japan.

REALITY: Not true. Japan is no more protectionist than the United States. This is the conclusion of The Heritage Foundation's *Index of Economic Freedom*, which measures the relative level of economic freedom in over 100 countries. The study concludes that Japan and the U.S. have relatively equal levels of protectionism.[5]

The trade deficit with Japan is not nearly as bad as deficit "hawks" argue. For example, while the U.S. ran up a $66 billion merchandise trade deficit with Japan in 1994, it had a $16 billion trade surplus in services. Thus, the real deficit was only about $50 billion. Moreover, much of the trade deficit with Japan comes from counting the products of American companies exporting their goods back home. But why should the importation of products made by American companies in Japan be counted against the deficit merely because they were manufactured in Japan? The profits from these sales go to the stockholders of American companies, not directly to the Japanese.

The truth is that Japan is the largest overseas export market for the U.S. Japan imported $51 billion in goods from the U.S. in 1994. That is more than the U.S. exported to the United Kingdom and Germany combined ($25.9 billion and $18.7 billion, respectively).[6] Moreover, on a per capita basis, Japan buys more from the U.S. than the U.S. buys from Japan. For example, each Japanese citizen bought $444 worth of U.S. goods and services in 1994, while each American citizen purchased only $441 worth of Japanese goods and services.[7] But because Japan's population is about 50 percent smaller than America's, a deficit exists. Americans purchase more Japanese goods overall because there are twice as many Americans as Japanese. Thus, a trade deficit exists for many reasons, but Japanese protectionism is not the major reason.

3 "Survey of Current Business," U.S. Department of Commerce, March 1995.

4 *International Financial Statistics*, International Monetary Fund, June 1995.

5 Bryan T. Johnson and Thomas P. Sheehy, *The Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation, 1995).

6 "Survey of Current Business," March 1995.

7 Based on figures in International Monetary Fund, *Direction of Trade Statistics Yearbook, 1994; Direction of Trade Statistics Yearbook,* monthly updates, 1995; and *The World Bank Atlas: 1995.*

MYTH #6: Trade deficits are always the result of government policy. Protectionists are fond of arguing that trade surpluses are "created" intentionally by government policy. Thus, they reason, trade deficits must be dealt with in the same manner—by government action.

REALITY: Not true. Those who argue that trade surpluses and deficits are the result of government manipulation fail to understand how a market economy works. They ignore, for example, that some countries with scarce natural resources are likely to run a trade surplus because they must import unfinished goods, which are inexpensive, and export finished goods, which are more expensive. Japan is a case in point. It must import such raw materials as oil and lumber. These raw materials are used to manufacture more expensive finished products, some of which are exported. Throughout this process the Japanese are adding value to the imported raw materials by making more expensive finished products for export. The result is a trade surplus. By contrast, the U.S. has abundant natural resources, which in many cases it exports. Thus, most of its imports are finished goods, which are more expensive and worth more than the raw materials that went into making them.

MYTH #7: Trade retaliation is the most effective way to eliminate trade deficits. Protectionists believe the best way to open foreign markets is to threaten trade retaliation. The weapons of choice: special tariffs and duties and the imposition of import quotas.

REALITY: Not true. The U.S. has resorted to such tactics to open foreign markets, but whether they have worked is debatable. Most of the time, these threats have backfired. The principal U.S. law used to threaten trade retaliation is called "Section 301." This refers to Section 301 of the 1974 Trade Act, which grants the President the authority to impose punitive trade restrictions on imports. Of the nearly 80 Section 301 cases initiated by the U.S. since 1974, only about 15 were successful. Yet even in these cases, American consumers were saddled with billions of dollars in higher prices caused by higher tariffs and special duties. In the end, all Americans were the losers in this flawed strategy.

MYTH #8: Trade sanctions to redress imbalances will protect American jobs. Trade deficit "hawks" argue that forcing open foreign markets will create U.S. jobs.

REALITY: Not true. The history of managed trade shows that even though one industry may benefit temporarily from government help, the cost to other industries and to U.S. consumers outweighs these benefits. Years of import restrictions on textile and apparel products, for example, have destroyed far more retail jobs than they have created or saved in textile manufacturing. Moreover, while some jobs were saved in the steel industry as a result of import restrictions on foreign steel, far more jobs were destroyed in industries that use steel. Import restrictions increased the prices of finished products that use steel, forcing businesses to spend more money on raw materials than on creating new jobs.[8] In short, the higher prices paid for domestic steel drove up the costs of

8 James Bovard, *The Fair Trade Fraud* (New York: St. Martin's Press, 1991).

automobiles, machine tools, and appliances, and these higher production costs stifled job growth in these and other industries.[9]

CONCLUSION

The driving force behind the Clinton Administration's threat of trade sanctions against Japan and its other managed trade policies is a misguided belief that trade deficits are harmful to the economy. Nothing could be further from the truth. Trade deficits are a sign of strength. They often represent a growing economy in which jobs and wealth are being created, not lost.

Another myth that inspires the managed trade policies of the Clinton Administration is that trade deficits are mainly the result of closed markets overseas. Not true. There are many markets for U.S. goods and services overseas. In fact, the U.S. is the largest exporter in the world.

The Clinton Administration misunderstands America's position in the international economy. It has wrongly assessed America's massive export strength. It has wrongly assessed the implications of America's trade deficit. And it has wrongly assessed the reasons why Japan has a trade surplus. As a result of these misjudgments, the Administration has adopted a managed trade policy toward Japan and other countries that could threaten the wealth and prosperity of all Americans. This is a high price to pay for a belief in myths.

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9 See Bryan T. Johnson, "Ending America's 20-Year Addiction to Steel Import Restrictions," Heritage Foundation *Issue Bulletin* No. 146, April 21, 1989.