The Trade Deficit: Causes and Cures

Murray Weidenbaum

Murray Weidenbaum is chairman of the Center for the Study of American Business at Washington University in St. Louis.

When humorist Dave Barry devotes an entire column to the trade deficit, as he did recently, we know that it's time that economists turn their attention to this important measure of economic activity. Unfortunately, economists lack Barry's ability to penetrate quickly to the heart of the matter.

Thus, Barry links the trade deficit to brassiere ads and to toenail clipping. As he would say, I'm not making this up. But, alas, I must turn to somewhat more esoteric aspects of the topic.

We must acknowledge at the outset that economists tend to downplay the role of the $300 billion trade deficit in an $8 trillion economy. After all, that large excess of imports over exports has not prevented the United States from enjoying an unusually long period of economic growth coupled with very low rates of inflation and unemployment. In fact, the trade deficit—via low-priced imports—has provided an important short-term positive. It has been a key mechanism in maintaining low inflation without the need for the substantial amount of monetary restraint that normally accompanies this late phase of the business cycle.

The Structural Imbalances Facing the U.S.

Nevertheless, examining the economy through the prism of the trade deficit does bring to light important and fundamental imbalances that deserve our attention. For starters, of course, the United States imports more than we export. That means that, as a nation, we consume more than we produce and, as individuals, we spend more than we earn. As a result, in the aggregate, we invest more than we save and we borrow more than we lend which, of course, is what the current account deficit is all about.

In the interrelated economy in which we live, these measures of imbalance generate a host of political pressures to alter public policy. A record trade deficit, for example, invariably provides ammunition for those who wish to "protect" American businesses and their workers from "unfair" foreign competition. (A cynic might note that the only "fair" type of foreign competition, in this view, is the kind that is not very effective in gaining any share of the domestic market.)

In a more positive way, the pressure of foreign competition—as exemplified by the trade deficit—also encourages improvements in productivity, quality, and innovation. However, these desirable effects are less dramatic and take longer to achieve.

Let us turn to another way of measuring the structural imbalance in the American economy, the inadequacy of domestic saving. That shortcoming results in proposals to reform taxation by exempting or at least deferring saving from federal taxation. Unfortunately, such fundamental reforms of the tax system are not on the short-run policy agenda.

High rates of borrowing, as evidenced by rising consumer indebtedness, worry people who believe that financial regulatory practices need to be tightened. Financing the large current account deficit in turn raises a very different array of concerns. These worries include mainly the state of monetary policy and the strength of the dollar in world currency markets.

Of course, there is a rather simple and direct way of reducing the trade deficit: slow down substantially the economic growth rate of the United States. You might want to put that approach in the category of “the cure is worse than the disease.” If the economies of our major trading partners accelerate at the same time, so much the better. Recent historical data certainly confirm two related facts. The trade deficit goes up in periods of rapid growth. It declines when the performance of the economy deteriorates. For example, in 1992, the United States went into recession and the trade deficit came down. The next year, the economy revived. Surprise of surprises, the trade deficit rose.

This is not just a domestic phenomenon. In 1996, South Korea “suffered” a trade deficit with the United States—and its economy was prosperous. In 1997, the Korean economy went into the tank—and that nation started to run a trade surplus with us. Of course, the structural or secular effects remain, regardless of the state of the business cycle.

Some of those structural aspects reflect the peculiar economies of other nations. For example, it is well known that we import far more from Japan than we export, and that this situation reoccurs year after year. However, few of us realize that the average Japanese spends more on U.S. products than the average American spends on Japanese products. The per capita numbers in 1996 were $538 versus $432 in our favor. But, of course, we have a far larger population (more “capita”) than they do.

Should we then worry about the trade deficit? I think so. In the longer term, our continuing trade deficit results from the basic economic imbalances I discussed earlier. Viewed in this context, our large trade deficit may not be sustainable in the long run. Here is a hypothetical scenario.

For some reason, major foreign suppliers of capital might reduce their outflow of finance to the United States. Precipitating actions could range from bilateral military concerns in China to domestic political or economic problems in Japan. A scarier, and less likely scenario, would be a reflow of their capital out of the United States, notably large sales of U.S. Treasury securities. On the comforting side, it would be harder to conjure up the circumstances under which such an eventuality would occur.

In any event, the reduced inflow of foreign capital would not occur in isolation. It would set in motion actions that would constitute an adjustment process albeit somewhat painful at times. Thus, less new capital inflow likely means less new investment in the United States. It also means higher domestic interest rates to attract the capital that we do obtain. Both of these factors move the economy in the same direction—a slower path of growth. That also tends to reduce the trade deficit.

If the cessation of foreign capital inflows is rapid and large enough, the United States could conceivably experience a recession. That would be more likely, of course, if the economy otherwise were slowing down substantially. That would not be exactly the end of the world—even in this millennium period. Yet, all this demonstrates the point that large trade deficits are not painless. They do increase our vulnerability to overseas economic and financial developments.

Possible Policy Responses

Thus, it is possible that policymakers and those that advise them would at some point try to deal with the trade and other fundamental imbalances facing the American economy. Let us examine the range of possible policy responses to the trade deficit. For ease of analysis, let's divide these government actions into short run and long run. Short-run policies can be carried out quickly in a year or so. The long-run actions, at least as I'm defining them, take a lot longer to register significant effects.

In the short run, we can try, as our government periodically does, to get foreign governments to reduce their barriers to our exports. Existing trade legislation provides some leverage on this score, but an appeals process via the World Trade Organization may delay or even block the impact. As a practical matter, most tariffs in the industrialized nations have come down very substantially in recent years. This has been the result of several rounds of GATT-sponsored multilateral trade negotiations. Quantitative restrictions and other non-tariff barriers, however, require much more individualized responses.

In any event, our hands are far from clean. We Americans like to view ourselves as an island of free trade in a world of protectionism. As anyone who has been involved in international negotiations can quickly attest, there is no shortage of import restrictions on the part of the United States. Our foreign counterparts are fully knowledgeable on that score and do not hesitate to remind us, in embarrassing detail.

Oddly enough, we can do much to reduce what I call self-inflicted wounds—the barriers that we raise to our own exports. These arise from many sources. They include efforts to protect technology vital to the national security, concerns about the environment of the nations we trade with, and domestic political and economic pressures. Most of these bureaucratic obstacles generate the same adverse side effects: they reduce the confidence of foreign customers in the United States as a reliable supplier.

Soybeans are a classic case of such a self-inflicted wound. Some years ago, in an effort to contain domestic inflation, our government embargoed the export of soybeans. To Japan, of course, the assured supply of soybeans is a vital matter. Japanese business interests quickly invested in building a new soybean growing capability in Brazil. The United States soon lifted the embargo. But our soybean producers never regained their earlier position in the world market.

As a general proposition, our short-run leverage to reduce the trade deficit is rather limited. The United States is simultaneously the world's largest importer—and the world's largest exporter. We have a fundamental stake in an open global marketplace.

In the longer run, of course, we do have far more leverage in altering the conditions that generate those huge trade deficits. That is, we can deal with the fundamental imbalances that I enumerated earlier. One way of responding to foreign competition is to reform the many onerous regulations which unwittingly encourage American companies to locate new research and production facilities overseas. U.S. medical device manufacturers, thus, often now set up shop in the Netherlands. That is hardly a low-cost operating environment. Nor do the Dutch neglect the regulation of health-care products. However, the Netherlands is known for maintaining an enlightened regulatory system that achieves its objectives with relatively low burdens on the companies being regulated.

Other regulatory programs generate similar effects. Overly stringent domestic environmental requirements encourage American oil companies to explore in faraway Kazakhstan and in western China's Tarim Basin and U.S. mining companies to drill in Bolivia.

What about the long run? To put it bluntly, it does not begin during an extended presidential election campaign. Meanwhile, the political responses are heating up. As we saw in Seattle at the time of the trade negotiations, the voices of protectionism take many forms.

The newest, and often the most effective, exponents of economic isolationism are the more activist elements of the environmental movement. To put it kindly, consistency is not their long suit. After great success in keeping economic considerations out of most environmental statutes and regulatory processes, they contend that it is only right and fair that trade and other economic policies should take full account of environmental considerations.

The unions are in a sense far more straightforward, albeit self-serving. They are responding to what they see as their high-minded interest in promoting high labor standards abroad. Like any producer group, they object to low-cost competition and vehemently so if it comes from overseas.

The fundamental problem for those of us who try to defend the high ground is that trade—as so many other aspects of life—generates winners and losers. The net excess of winners is pervasive. But, unfortunately, it is one of those arcane statistical artifacts that do not arouse much public support. Moreover, those hurt by imports feel the impacts directly and often substantially. In contrast, the benefits of trade are more widely distributed and not so obvious.

To cite the most basic example, we are keenly aware of the foreign products in our homes. We rarely see the American products that are in foreign homes. In effect, the losers know who they are but the far larger number of winners don't. That is so because, in good measure, the gains to the average citizen are more indirect and modest, even though in the aggregate they really mount up.

In this difficult and controversial area, Congress has responded with—this may not exactly be shocking news—a new blue ribbon commission. I happen to chair the distinguished aggregation of six Republicans and six Democrats that is charged with identifying the causes of and cures for the trade deficit. Getting agreement on a single bipartisan report will be more than a challenge. The Associated Press already dubbed our effort to avoid separate partisan reports as "Mission Impossible." Nevertheless, we are determined to meet our self-imposed goal of a unified report.

We have held two days of technical briefings in Washington, where we heard from a variety of experts—right, left, and center. The Trade Deficit Review Commission is now holding hearings around the country. This congressionally imposed requirement enables us to hear directly from the various groups that have a stake in international trade. All this should be helpful in writing our report, which is due in August 2000. Yes, we noticed that will be in the midst of a presidential election campaign.

Meanwhile, I can offer a few rudimentary forecasting tools, albeit with tongue in cheek. First of all, there is a positive correlation between the activity of our commission and the size of the trade deficit. The longer we are in office, the bigger the deficit. It is not hard to envision a $400 billion excess of imports next year. But, take heart, matters will improve when we close up shop. I confidently predict that, from the day that our report is issued next summer, the deficit will start coming down. That will be a real display of effectiveness.

The Outlook

Seriously, the outlook for the years ahead is for the trade deficit to narrow as the economies of other major trading nations rise relatively to the somewhat reduced pace of U.S. economic growth. A weaker dollar may well be a part of the solution as foreign economies recover and foreign investment opportunities become more attractive.

Most fundamentally, however, the American economy is strong in all of the characteristics that make for long-term global economic success. Analysts of the global economy generally agree on the six key factors that provide the strategic difference:

- An economy open to foreign trade and investment. Most successful economies avoid the path of economic isolation.
- A government that minimizes controls over business.
- A judicial system that works well and helps minimize corruption.
- Greater openness in business decision making and increased availability of economic information to producers and consumers. This is the opposite of the "buddy" system, in which people do business mainly with friends and relatives.

- High labor mobility. This enhances productivity and generates higher living standards. To the uninitiated, labor mobility sounds like insecurity, but the reverse is true. Where it is hard to lay off workers, we find a dearth of new job creation.

- Ease of entry by new businesses. Competition limits complacency and protects the consumer far better than any government intervention can.

The United States may not be a 10 in all of these categories, but we surely rate very high in each one of them. Moreover, the American business system possesses several unique advantages that give many of our companies a leg up in international competition. These are a strong entrepreneurial spirit, a "small cap" stock market for small and midsize firms, rapidly advancing technology, comparatively low taxes, a low rate of unionization, and a world class system of higher education.

As more people around the globe come to appreciate the benefits that flow from our combination of economic freedom and personal freedom, an optimistic outlook for the years ahead is more likely to be achieved. Because we are the pacesetter of economic progress, the United States remains the envy of the world. We must be doing something right. Ω