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Trade's Truths and Canards

By W. Michael Cox and Richard Alm

Trade should be simple. A buyer and seller agree on price, quantity and other details, then an exchange takes place, with money going one way and goods the other. The buyer may grouse about paying too much and the seller might mutter that the price could have been higher—but both go on their way having made themselves better off.

This must be true when transactions are *voluntary*, each side willingly giving up something they had for something they valued more highly. Voluntary and legal transactions are the routine stuff of economic life, taking place millions of times every day within the United States. For the most part, we accept that consumers have every right to use their money as they see fit. Nobody else should tell them what to buy, how much to pay or who to buy from—unless the transaction is immoral.

Buying and selling don't generate much controversy until they cross one of those lines on the map that demarcates the border between one country and another. Then voluntary transactions often become threats to the U.S. economy, our jobs and welfare, and in some cases even national security—at least in some people's eyes.[1] Next comes the clamor to protect the country from imports—it's a scenario that goes back as far as the early 1800s.

Opposition to foreign trade waxes and wanes, often depending on how well the economy is performing. Hard times tend to fuel protectionist sentiments. In the past year or so, the United States has had an unusual combination of a booming economy and rising protectionist sentiments. Traditional U.S. support for freer trade, strong job growth and low unemployment haven't cooled the animus against imports.

Economists are a contentious lot, but they're nearly unanimous in concluding that trade protection raises consumer prices, slows economic growth, reduces efficiency and in the end *destroys* jobs. No matter what the economists say, or how often they say it, misconceptions about trade still plague the public debate.

President Trump was elected on rhetoric skeptical of the mutual benefits of trade. He disparaged America's agreements with other countries and vowed to close the U.S. trade deficits. In office, he's maintained that posture, this year shifting from saber-rattling to taking action against imports. His administration raised tariffs, first on aluminum and steel, then on a range of products from China. Other countries retaliated by raising their tariffs on U.S. products, such as soybeans.

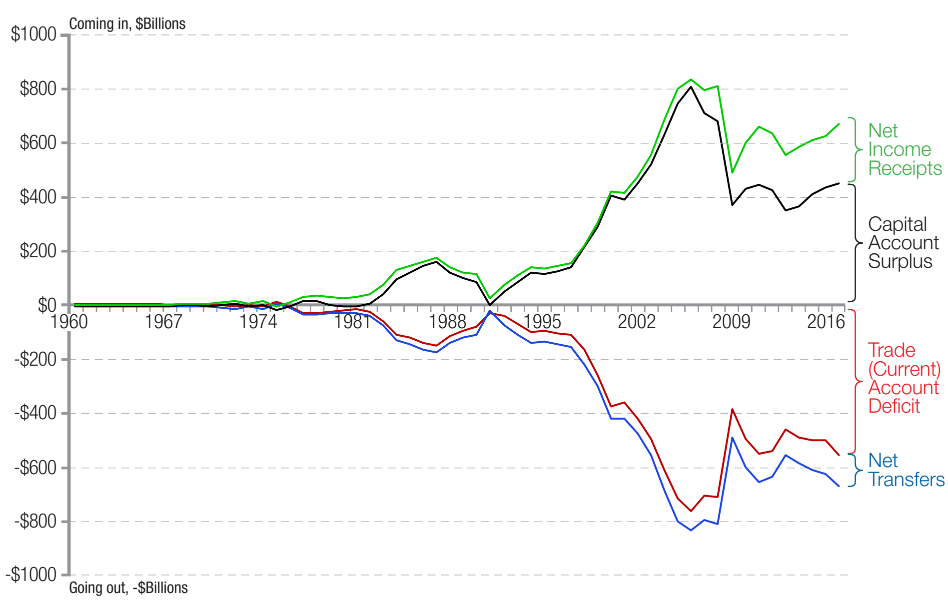
Many contend that the United States is in a trade war—with China at least. With so much going on, it's a good time for a dose of economic wisdom that separates the truths from canards on trade.

DISAPPEARING DEFICITS

Other countries are taking advantage of the United States—and our enormous and persistent trade deficits prove it.

On goods and services trade, America's imports have exceeded its exports every year since 1975 (*see chart below*). The

Doing Business with the World: Money Going Out Equals Money Coming In



[1] Trade also crosses state borders, occasionally running into legal barriers. In some places, for example, laws restrict consumers to buying cars or alcohol from in-state sellers—for the benefit of these companies. These restrictions violate consumers' rights, but they rarely generate the outrage directed at imports.

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trade (or current) account gap swelled from $108 billion in 1997, alarming at the time, to almost $762 billion in 2006. The deficit has shrunk a bit, but it exceeded $552 billion in 2017—and the country's on pace for a larger deficit this year.

These numbers are the smoking gun for those who see trade as a raw deal for the United States. However, money going out as a result of the widely publicized trade deficit ignores a significant part of the country's global transactions. There's also money coming in—$222 billion in profits and royalties earned overseas and the capital account's $332 billion in net cross-border investment.

Net income receipts include U.S. overseas earnings—the take from the *Star Wars* business empire, for example. The other big part of it is money washing back from the hundreds of American franchises around the world—McDonald's restaurants, Marriott hotels, Hertz rental cars and 7-Eleven stores.

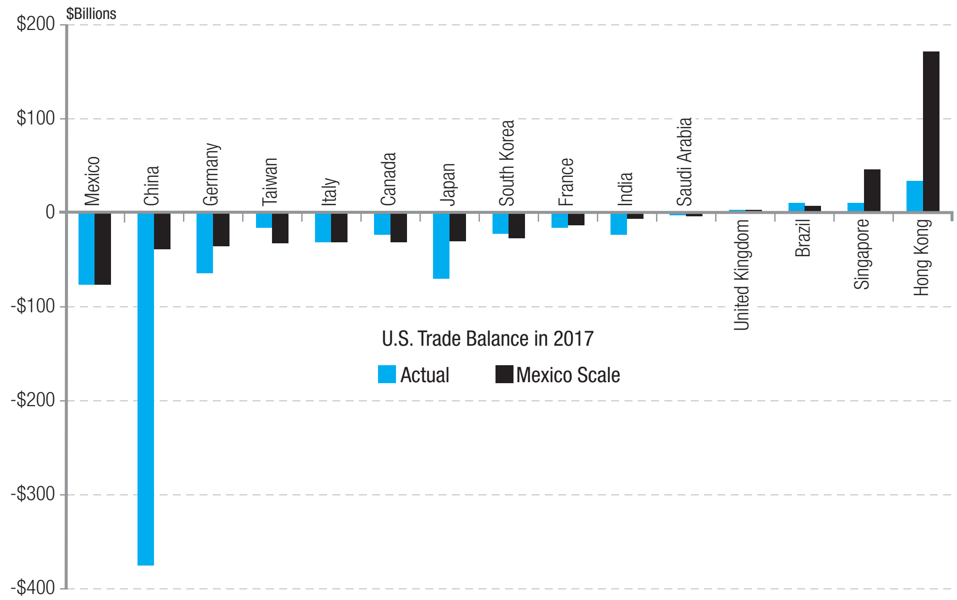
The capital account includes the money Toyota and other foreign companies send this way to build automobile plants. Incoming portfolio investment helps finance U.S. prosperity by purchasing Treasury debt, corporate bonds and equities. The foreign money helps keep interest rates low and stock prices high.

The trade account deficits that Americans lament are the way foreigners earn money to buy U.S. goods and services and invest in the U.S. economy. Each year, the millions of voluntary transactions between individual Americans and the rest of the world go roughly like this: goods and services come into the United States, money goes abroad to pay for them, then money comes back as foreigners buy U.S. goods and services and invest in U.S. assets, either real (companies and property) or financial (stocks and bonds).

Money going out and money coming in net to zero, except for relatively small statistical discrepancies. It's an accounting necessity—for the United States and all other countries. The trade balance always balances, just like assets and liabilities on companies' balance sheets always balance.

We can point to the deficit on the trade side of the balance of payments and proclaim the U.S. economy a loser. We can look at the surplus in the financial side and tout the United States as a winner, the place where the whole word wants to invest. Or we can take note of both sides and call international trade and finance balanced, neither side taking advantage of the other. Americans get what they want—a higher level of consumption. Foreigners get what they want—a stake in the U.S. economy.

U.S. Trade Balances—If All Economies Were the Size of Mexico



A BLIGHT OF UNFAIR TRADERS

Incoming financial flows may balance out the overall trade deficits, but their huge imbalances expose China and some other countries as unfair traders.

The United States ran a $376 billion trade deficit with China in 2017—by far the largest with any of our trading partners. Seeing that number, many Americans conclude that the Chinese must be cheating, closing their market to U.S. products while taking full advantage of the wide open U.S. economy.

Is China really the scourge of U.S. trade? Or is it just big … really big?

To find out, we compensate for China's overwhelming bulk by reducing its economy to the size of Mexico's. The U.S. deficit with its southern neighbor was $76 billion in 2017, second only to China's. If the two economies were the same size, the United States would actually have a bigger gap with Mexico.

On the Mexico scale, the U.S. trade deficit with China shrinks to about $38 billion in 2017—half the gap with Mexico *(see chart above)*. The deficit with China is now about the same as with Germany and not too much larger than Taiwan, Italy, Canada, Japan and South Korea.

Making China less of a trade beast doesn't diminish the country's protectionist practices. They're real, and the United States should press China to dismantle them. And China should do it—not to benefit American exporters but for the sake of its own people. The main victims of a country's trade barriers are its own citizens, forced to pay higher prices for goods and services.

That goes for the United States as well. Americans typically harp on foreign trade barriers. In doing so, they ignore the burdens the United States puts on imports—to the detriment of its consumers. In the most recent *Economic Freedom of the World* report, the United States was a middling 56th among 157 nations in freedom to trade internationally.

Getting rid of foreign trade barriers won't end U.S. trade deficits. With its high level of consumption, the United States doesn't save enough at today's

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interest rates to meet its borrowing needs, including the federal government's deficit, which exceeded $800 billion in fiscal year 2017-8. Until the United States consumes less and saves more, the country will need large and regular capital-account surpluses, which will mean continued trade-account deficits.

Protectionism won't restore U.S. manufacturing to its former glory. It will just raise prices, hurting consumers, producers and eventually the whole economy.

FACTORY FALLACIES

Competition from foreign imports has devastated America's manufacturing, so it's in the national interest to reduce imports in an effort to bring back U.S. jobs.

Reports of American manufacturing's demise have been greatly exaggerated. The country's factories churned out nearly $2 trillion in total output in 2017—more than any year in history. U.S. goods producers remain highly competitive globally, their exports nearly doubling from an inflation-adjusted $838 billion in 1999 to more than $1.5 trillion in 2017. America still makes things—but services jobs account for 80 percent of the country's total.

Producing more output with fewer workers—well, that's how the country got rich in the first place. Even so, many Americans believe prosperity lies in restoring the *status quo ante*, with the U.S. economy bringing back millions of lost manufacturing jobs. Technology destroyed 80 percent to 90 percent of those jobs, but many Americans still see salvation in cutting competition from imports.

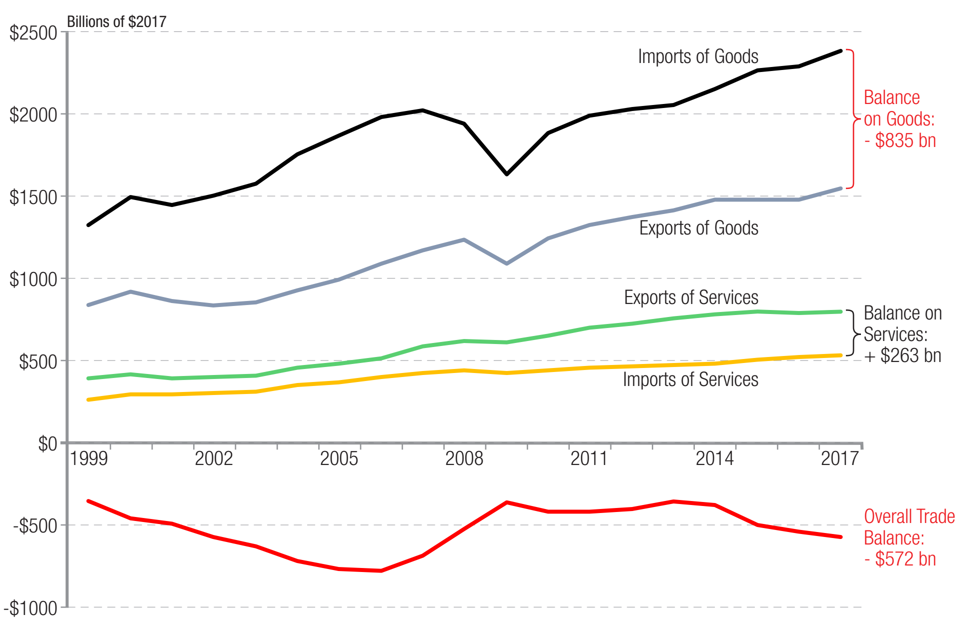
Decades ago, the United States left behind low-tech manufacturing like textiles, apparel and toys; today, foreigners can produce appliances, electronics and steel at lower cost. The cutting edge of U.S. growth and the best jobs prospects lie in high-technology industries—i.e., Silicon Valley and its cousins—and professional services—i.e., finance, entertainment, design and marketing.

Knowledge-based services in particular are America's forte when it comes to selling to the rest of the world. In 2017, services exports approached $800 billion, double the total in 1999 and the most of any country *(see chart below)*. Exports exceeded imports by $263 billion, suggesting a strong U.S. comparative advantage in tradeable services. Combined with the net positives in foreign earnings and the capital account, the growing services surpluses offset the deficits in the trade account.

The United States holds big edges in financial services, education, entertainment, legal services, architecture and construction, leasing and medicine. Services trade will continue to grow because barriers are falling around the world and technology is overcoming the economic impediments. U.S. exports of medical services, for example, are relatively small—but robotic surgery allows U.S. doctors to stay at home and operate on patients almost anywhere in the world.

Protectionism won't restore U.S. manufacturing to its former glory. It will just raise prices, hurting consumers, producers and eventually the whole economy. Trade policy might help workers in industries favored with high tariffs—like steel. It will hurt far more workers in industries that see sales decline because they pay more for steel inputs. Trade policy can alter the composition of jobs, but it can't increase overall employment.

Trends in U.S. Trade: Deficits in Goods, Surpluses in Services



THE IMPORT OF IMPORTS

Even if the balance of payments always comes out even, exports are good for the economy and the United States should sell as much as it can abroad. Imports are bad, and we should buy as little as possible overseas.

The America First stance on trade is completely and tragically backward. Exports aren't the gain from trade; they're the *cost*. Imports aren't the burden from trade; they're the *benefit*. To see it more clearly, keep an eye on what really matters for living standards—who does the work and who gets to consume.

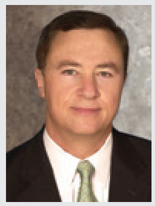
Start with exports. We work and employ

our resources to produce something useful—a Ford minivan, for example. Then the fruits of our labor get packed into the hold of a ship and sent to some other country for their consumers to drive. We'd be foolish to give away a minivan or other goods for nothing—so foreigners send back some money. Because export transactions are voluntary, the U.S. seller and the foreign buyer both end up better off.

Now turn to imports. Foreigners do the work, and we get all sorts of things that make us happy—German cars, Chinese electronics, Italian shoes, Chilean wines, Mexican granite, to name just a few. Some of the imports cost less; others win through style, quality or availability. Like Americans, foreigners aren't foolish, so we won't get to consume their products unless we send them some of our money. As with exports, the import transactions are voluntary, leaving both sides better off.

Imports deliver some other benefits. By providing competition for domestic companies, they help keep prices low. Imports also boost exports. Not only do they give foreigners the money to buy U.S. products, they also help U.S. companies lower production costs and stay competitive on world markets.

By itself, exporting reduces our living standards. We're only better off when we take the money foreigners pay for our exports and buy the imports that raise our living standards. In fact, the sole sensible reason to export is to import. Otherwise, trade's all work and no play.



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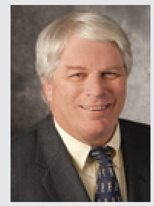

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CHARTING THE ECONOMY

Economic Freedom Rises, Falls Among World's 12 Largest Economies

The newly released *Economic Freedom of the World (EFW)* report offers good news for the United States. It rose to sixth in the rankings, up from 11th in last year's report.

A measure of commitment to markets, economic freedom is important because higher scores correlate with faster growth, higher incomes, lower poverty rates and other positive outcomes.

Setting aside Brazil for a moment, economic freedom in the 12 largest economies has bunched since 2000 *(see chart)*. The United States and United Kingdom remained the group's freest economies, but their scores have been drifting downward, even with the U.S. reversal in the past few years.

Once near the bottom, Indonesia posted the biggest improvement in economic freedom. China and Russia showed steady gains. India was a bit erratic. Then there's Brazil—it gained economic freedom for a decade, then its score took a plunge, finishing below where it was in 2000.