Why the Trade Deficit Is So Large and Why It Matters

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On October 13, the Commerce Department will report the August deficit for trade in goods and services. The July deficit was $57.9 billion, and the August number may be a bit larger or smaller. Either way, it will be too large, and we need to ask why it persists.

From January 2002, the deficit on trade in goods and services has risen from $29.9 billion to $57.9 billion, and is now about 5.5 percent of GDP. Only $12.3 billion of that jump may be attributed to petroleum imports. The balance of the increase was a deteriorating position on nonpetroleum goods and services.

Budget Deficit Sophistry

In the discussions about the trade deficit, a great deal has been made of the U.S. federal budget deficit; however, during the second quarter the current account deficit, which includes goods, services, investment income and transfer payments, was $196 billion but the federal deficit was only $70 billion.* The budget deficit, and the foreign borrowing to finance it, is less than half the problem.

In 1991, the federal budget deficit was huge and the current account was in surplus. When Bill Clinton left office in 2001, the budget was in surplus and current account deficit was in deficit. That is the absolute opposite of what those who blame the trade deficit on the budget deficit would have us expect.

Of course the budget deficit matters but so do a lot of other factors. That said, it is hard to find good reasons for the rest of the problem in the competitive fitness of U.S. business.

Each year the World Economic Forum computes a growth potential index for 117 economies. It examines factors like public finances (e.g., budget deficits, efficacy of the tax system), the environment for the cultivation and commercialization of technology, and quality of civil institutions (e.g., the prevalence of corruption, evenhandedness of the judiciary and respect for law), and openness to international competition. In this assessment of national competitive potential, the United States ranks second after Finland—China and India rank 49th and 50th. Also, the WEC ranks the fitness of businesses, and on that score the United States ranks first—India ranks 31st and China 57th.**

Our labor force is much stronger than education entrepreneurs in search of higher taxes would have us believe. Virtually our entire native born population finishes high school, two thirds receive some post secondary training, and our universities are among the nation's most prolific export industries. The most important determinant of quality in the classroom is the student population, and if our universities are populated by dullards, why do so many foreign students want to pay our pricey tuition?

U.S. productivity is advancing briskly. Since 1999, private business productivity has increased 3.2 percent a year; in durable goods manufacturing, where technology matters as much as anywhere, productivity has been advancing at a 5.4 percent pace. We have to go back to electrification, the railroad and the opening of the West to find epic events that so transformed

our economy and the global economy as contemporary American innovations in new materials, electronics and logistics.

So where is the problem? I suggest we look in three places.

Broken Industrial Policies

Despite the generally good U.S. policy environment, certain industry policies place undue burdens on the growth of export and import-competing sectors and push capital and labor into other industries. Most important among these are policies that weigh heavily on manufacturing, and in particular durable goods manufacturing where so much competitive potential seems unfulfilled.

> Americans pay about 50 percent higher prices for health care than do competitors, for example, in Germany and France. Whether these prices are paid through premiums to private providers or taxes for government delivery systems, these higher costs heavily burden employers with union contracts requiring rich benefit requirements, or where benefit expectations are established by competing unionized employers.
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> Environmental policies raise costs in U.S. energy-intensive industries above those in Western Europe and elsewhere. For example through Republican and Democratic administrations, U.S. policy has encouraged the use of natural gas in electrical generation while limiting natural gas development. Regulation and litigation make it very difficult to build large LNG terminals to import gas anyplace but in the Gulf region, and have made it impossible to build a new petroleum refinery in more than 25 years. Sadly, higher natural gas prices are driving petrochemical manufacturers to Europe to find cheaper feedstock. Other industries adversely affected by dysfunctional energy policies include plastics, metals and industries fabricating those materials.
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> Our legal system relies more heavily on case law and torts to protect private interests but it can be abused. Too frequent and expensive lawsuits visit particularly on durable goods manufacturing where liability extends as long as the product is in use, even if ownership of the company has changed several times or the assets have been reorganized by bankruptcy.

Overall, the National Association of Manufacturers has estimated higher benefits costs, regulatory compliance costs and lawsuits add nearly 13 percent to U.S costs that foreign competitors do not bear. These bias growth toward non-goods producing activities, and we import more and export less in the bargain.

Poorly Written and Enforced Trade Agreements

U.S. trade deficits have been driven up by the ineffective negotiation and implementation of trade agreements. These have permitted, for example, China to subsidize manufacturing with zero interest loans and pirate intellectual property, EU governments to underwrite Airbus with risk-free capital from government treasuries, and most industrialized countries to rebate value added taxes on their exports to the United States. Many governments require U.S. investors to give away technology, source components locally that might be more cost-effectively made here, or hit export goals.

The United States is much more dependent on personal and corporate income taxes to finance government than the EU and other countries that levy substantial value added taxes. U.S. trading partners may rebate their value added taxes on exports and impose these levies on imports. An arbitrary interpretation of WTO rules prohibits the United States from making similar border tax adjustment on its exports and imports.

The standard value added tax in the EU is averages about 19 percent, and when rebated on exports and applied to imports—these adjustments provide a 19 percent subsidy on EU products sold in U.S. markets and a 19 percent tax on U.S. products sold in the EU market.

The United States has acceded to special and differential treatment in the WTO that permits developing countries to maintain much higher tariffs on manufactured products, and affords them weaker enforcement on a whole range of issues from subsidies to intellectual property to conditions imposed on U.S. investors. As a consequence, U.S. firms move production to developing countries to scale tariff barriers—consider Brazilian and Chinese auto tariffs—and then they encounter all kinds of pressure to transfer technology and move the suppliers of critical components production into these markets. And, the steel, plastics and microprocessors are then not made here!

The Bush Administration seems bent on repeating the mistakes of the past. It is not making parity in tariffs a bottom line requirement for Doha negotiations, foreign government latitudes to lay on subsidies will likely emerge substantially in tact, rules for foreign investment and exchange rate manipulation are not on the table, and U.S. dumping and subsidy/countervailing duty laws, which provide the only real defense against these subventions and abuses of free and open trade, are under assault with only tepid defense from U.S. negotiators.

Currency Manipulation

Perhaps the largest single problem is the almost complete absence of meaningful disciplines for exchange rates, which the Bush Administration has chosen not to effectively address. Since January 2002, the dollar is down an average of 14 percent against all currencies. The dollar has fallen an average of 24 percent against the euro and other industrialized country currencies, but it is up an average of about 1 percent against the Chinese yuan and other developing country currencies.

The Chinese 2.1 percent revaluation announced July 21 was too small to significantly affect the value of the dollar or have a measurable effect on trade. The Chinese yuan remains fixed at about 8.1 per dollar thanks to substantial Chinese government purchases of dollars; other Asian central banks continue similar currency policies lest they lose export markets in the United States and elsewhere to China.

Chinese government purchases of dollars and other securities easily exceed $200 billion per year and 12 percent of China's GDP. Chinese government purchases of dollars and other securities create a 33 percent subsidy on China's exports.

Overall China and other foreign governments are purchasing more than $82 billion in the second quarter of 2004, creating a 17 percent subsidy on the sale of foreign goods and services to Americans.

What Are the Consequences?

Apologists for the trade deficit argue that it indicates the strength of the U.S. economy, because it is financed by productive investments in U.S. industry. That is less than half true. Most of the capital we import to finance our nearly $800 billion dollar current account deficit goes into foreign holdings of U.S. securities—U.S. government bonds, bank deposits, corporate bonds, and the like. These now total about $5 trillion dollars and are growing at a pace of about $500 billion a year—that's more than half the trade deficit. And not all of these are private investors seeking haven from the uncertainties of foreign capital markets—remember about $395 billion of those $500 billion in paper assets purchased in 2004 went in the coffers of foreign central banks.

At five percent a year, the debt service comes to $250 billion and that debt services increases at about $25 billion a year. Do you think our kids should be saddled with that? If so, feel comfortable in the knowledge that borrowing for a wild spending spree on imports today to saddle your kids with debt is building a sound America for tomorrow.

Further, persistent U.S. trade deficits undermine U.S. growth. These shift employment away from export and import-competing industries, which enjoy higher productivity and pay higher wages. Trade deficits are a key reason why the wages of most workers with only a high school education or a few years of college have barely kept up or lost ground against inflation during the recent economic recovery.

U.S. manufacturers are particularly hard hit. Cutting the trade deficit in half would create nearly 2 million more manufacturing jobs. An effective policy to end currency manipulation and cut the trade deficit would particularly benefit highly competitive U.S. durable goods manufacturers, such as producers of machine tools, industrial and construction machinery, auto parts, and electronic equipment.

U.S. import-competing and export industries spend at least 50 percent more on R&D and encourage more investments in skills and education than other sectors of the economy. By shifting employment away from these trade-competing industries, the trade deficit is reducing U.S. investments in knowledge-based industries and skills and handicapping U.S. growth.

Slashing the trade deficit in half would add more than one percentage point to U.S. productivity growth and potential GDP growth each year.

*Net federal government savings.

**It is important to remember that China and India still have highly regulated economies and are troubled by corruption, and the legacy of Communism leaves China with fairly undeveloped infrastructure to support world class businesses. That is one reason both countries rely, for example, so much on conduits like Wal-Mart and Li & Fung to reach western markets.