Heritage Lectures
Published by The Heritage Foundation
No. 992
Delivered December 4, 2006
February 14, 2007

What Trade Deficits Really Mean

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The other day I was perusing a Web site that listed historical terrorist activity. Many people don't remember this, but in the late '70s and early '80s the world was experiencing an average of about 30 airplane hijackings every year; many of those occurred right here in the United States. Terrorism is, in a sense, new in how it's showing itself today, but it's not new in the sense that it's affected our country before.

At the same time as those hijackings, the U.S. was under siege from stagflation, double-digit inflation, and unemployment. The French hated us. (They still do.) If you remember, Ronald Reagan wanted to put Pershing II missiles in Germany and the French were burning photographs of him and American flags in the streets.

In this respect, not much has really changed.

Conventional wisdom fretted about the budget deficit and the trade deficit. We called them the twin deficits then. It's not surprising, by the way, that we don't hear much talk about the twin deficits today, because all of that analysis was really bad. What you do hear frequently these days is that we're profligate spenders, that our nation spends too much and runs a deficit. That's true. Our government does spend too much. But as for claims that our consumers aren't saving, this is patently not true. The savings statistics these claims are based on are very misleading.

We are by far the wealthiest country on the face of the earth, and the gains in that wealth and the amount of capital investment Americans make indicate we are among the best savers in the world. But the conven-

Talking Points

- Bad analysis about the U.S. trade deficit and the way the international financial system works contributes to the conventional wisdom that America has become increasingly reliant on foreign investment.
- As any accountant knows, when we have a trade deficit, there must be a capital surplus, because those dollars have to flow back into the United States. When the Chinese sell goods to U.S. companies in return for dollars, they have to do something with those dollars. Either they invest in U.S. assets or they purchase U.S. goods and services.
- People who don't trust the free market want to raise taxes or reduce the value of the dollar to fix the deficit. The International Monetary Fund has ruined hundreds of millions of people's lives over the past 40 years with that kind of policy.
- As we learned in the early 1980s, a tight money, strong dollar policy, with low taxes and free markets is the best way to create wealth.

This paper, in its entirety, can be found at:
www.heritage.org/research/tradeandforeignaid/hl992.cfm

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

The Heritage Foundation

tional wisdom is that our government doesn't save, that our consumers don't save, and that therefore we have to count on the largesse of foreigners to save for us. Specifically, we have to count on China to buy our Treasury Bonds to finance our war in Iraq or to keep our interest rates low so that the housing market stays strong. This is nothing new—just a repeat of what we heard 25 years ago updated for the modern era.

So I want to talk about this, because I think there's a lot of very bad analysis about our trade deficit and the way our international financial system really works. So, let's focus on trade for a moment

What Happens to Trade Dollars?

Wal-Mart, for example, buys \$20 billion to \$25 billion worth of goods from China every year. It buys those goods from thousands of different companies that are producing little trinkets or T-shirts or electronic equipment. Wal-Mart receives goods and our dollars go to China. Now, China is in a unique situation because at least until recently, there were very rigid controls on who could hold dollars in China. If you were a manufacturer in China and got dollars from Wal-Mart, you had to give those dollars to the Central Bank in exchange for yuan. Today, it's loosening up a little bit, but still it's not a free market.

Add OPEC into the equation. We buy oil in dollars. Dollars go to OPEC. So now we have all these dollars in foreign hands. Many people then turn around and say that foreigners lend us \$2 billion or more a day and if it weren't for this lending, our economy would fall apart.

But I want you to stop and think before buying into this argument. What choice does OPEC or China or any other entity outside the U.S. have once they get dollars? They really only have two choices. They either buy goods and services from the United States or they buy dollar-denominated assets.

OK, there really is a third choice. Suppose you are OPEC and you decide you don't like dollars and instead want euros. So you call up your German bank and the banker tells you the exchange rate. In an instant, with a few taps on a computer keyboard, the euros go to OPEC and the dollars go to the German bank. But then the German bank faces the same choice as OPEC. It has to buy goods and services from the United States or make an investment. It's much like the hot potato. Once the dollars are out of our country, they must come back one way or another.

There is a possibility of a fourth choice. If someone really doesn't want to make an investment in the United States, doesn't want to encourage those profligate Americans, and they really don't want to hold another currency, they can always convert their trade surplus into cash, put those dollars on pallets, and stick them in a warehouse. By the way, if someone actually chose to do this ridiculous thing, the currency would be removed from circulation and this would lead to a stronger dollar.

In the end, there are really only two paths for dollars to take. They must be used to buy goods and services or to make a U.S. investment.

Debits Also Mean Credits

Economists are too clever by half sometimes. There must be an accountant or two in this room. You know a lot more about economics than most economists do because you understand that for every debit there must be a credit. The accounts must balance. So, when we have a trade deficit, there must be a capital surplus, because those dollars have to flow back into the United States. And so the Chinese don't invest in the U.S. out of largesse or because they want to be nice to us; they do it because they have no other choice.

Now comes the fun part. People will ask: What if all these foreigners decided to boycott and not make investments in the United States anymore? Is that possible? What would they do? In reality, they can't do anything. If they decided not to make another investment in the U.S., they would be forced to spend those dollars on our goods and services. And if they did that, our trade deficit would disappear overnight. By the way, it would be virtually impossible for this to happen. The U.S. does not have the capacity to produce \$700 billion worth of goods and services and send them overseas in the next day or two. It can't happen.

Taking all this into account, it appears that the world has organized itself in the best way possible to lower the cost of production and the cost of economic activity to benefit the most people.

I was in Ireland about three and a half years ago. Hillary Clinton's autobiography had just come out, and her book was in the front window of every bookstore on the Island. I started thinking about this. Here was an American author with an American publisher. Do you think we printed those books here and shipped them overseas? No. At best we exported a computer disk to the printer (or a very large e-mail), and they printed the books, maybe in continental Europe, maybe in the U.K., maybe in Ireland, and then put them in the bookstores for sale. So, when you think about the trade deficit in a global, knowledge-based, intellectual economy, what does it in the end really mean? Apple makes about $40 from every iPod it sells. The manufacturer of the iPod—who happens to be in China—makes about $4 for every iPod that it produces. Would you rather have the intellectual value or the production value?

Now having said that, I want to tell you that the United States in the past year has produced more goods than it has produced in any 12-month period in its history. So, despite the trade deficit, we are still the world's largest exporter and the world's largest manufacturer. The facts do not support the rhetoric of the doom-and-gloomers. The U.S. economy is simply amazing.

Thriving with a Strong Dollar

Now, let's talk about the dollar, which has been weak in recent years. Many people argue that the dollar is falling because of this massive trade deficit. I say—baloney!

The trade deficit has nothing to do with the value of the dollar. What is the dollar, by the way? Why do we use it? The answer: Because it's more efficient than bartering. I don't have to carry around a side of beef on my back anymore. I don't have to carry around a big heavy bag of gold. I can use currency. Most money, in fact, never becomes currency and remains bytes in a computer. We use the dollar because it's a more efficient commodity to facilitate transactions than barter. The dollar is just a commodity. And what determines the value of a commodity? Supply and demand. That's all.

Who controls the supply of dollars? The Federal Reserve. It is the only entity in the world that can control the supply of dollars, putting aside the efforts of North Korean counterfeiters. And so if perchance the demand for dollars falls, all the Federal Reserve has to do is lower the supply of dollars. If they do, the value of the dollar won't change.

If you look at the past six or seven years, the Fed was too tight in 1999 and 2000 and the dollar soared. Then between 2001 and 2004 the Fed became accommodative—remember they drove interest rates to 1 percent—and guess what? The value of the dollar fell. When the Fed finally started to tighten in 2004, the dollar strengthened. Now they've paused and guess what? The dollar is weakening again. Why? In my opinion, because they paused too early. They're not tight enough yet. In fact, we're facing some inflationary pressures in the United States.

To bring this back to the beginning, the reason I'm talking about the trade deficit is that there are many, many people trying to use the trade deficit as a reason to support protectionism, dollar devaluation, and tax hikes. This is exactly the same policy prescription that the International Monetary Fund has taken around the world for the past 40 years and they have ruined hundreds of millions of people's lives with these policies.

Any push toward a lower value of the dollar to boost exports or tax hikes to limit demand for imports is harmful to the U.S. economy. It would be the exact opposite set of policies that we used in the early 1980s to end stagflation and economic malaise.

Faith in Free Markets

And so as we sit here today, I think we have a good fight in front of us. The political scene has changed dramatically in the past few weeks. Policies are beginning to shift and at the edges I sense some buckling knees on all of these policy prescriptions.

But in the end, as we learned in the 1980s and 1990s, a tight money, strong dollar policy, with low taxes and free markets is the best way to create wealth.

When we get off into arguments about whether a trade deficit is good or bad or whether the Chinese should or should not own this many or that many hundreds of billions of dollars worth of bonds, I always get worried because that's taking our eye off the ball.

What really separates a good economy from a bad economy is faith—faith that by following the right set of policies, and keeping the market free, you and I, the individuals in this country, will do the right thing. And while we seem to be slipping and sliding toward some bad policy decisions based on silly arguments, in the end, the U.S. body politic has tended to do the right thing. With the help of The Heritage Foundation, and others, we should all keep the faith that we will continue to do the right things. Have faith.

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