Written by Kurt Williamsen on March 23, 2015
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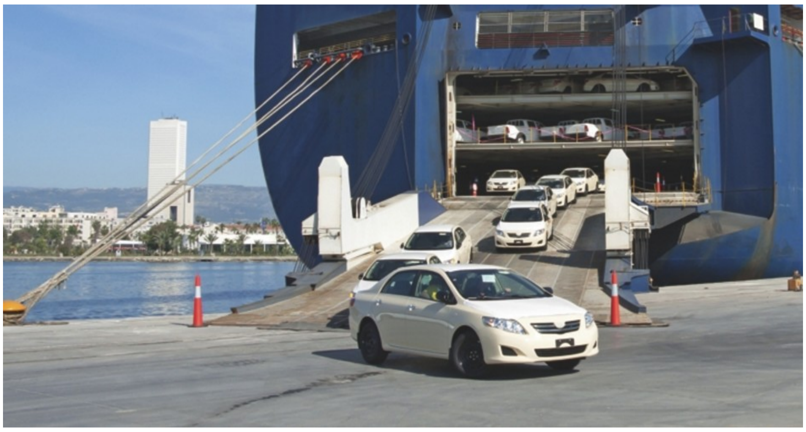
So I’m Told Trade Deficits Are Good



In 2013, the United States had a $471.5 billion trade deficit. In 2012, it had a deficit of $534.7 billion — more than a trillion dollars in just two years. Americans keep buying products from overseas — more than foreigners buy from the United States — to a large extent because government regulations in the United States make producing items here so expensive that U.S. companies have difficulty competing, because trade treaties give trade advantages to other countries, and because America imports large quantities of oil (oil represented roughly 35 percent of the U.S. trade deficit in 2014).

Using logic, many Americans deduce from our deficits that a situation is occurring similar to the following scenario: More U.S. imports than exports indicates less production here, fewer jobs here, fewer opportunities for advancement, lower wages, longer hours at the jobs that are available, and more years of work before retirement — if retirement comes at all.

They also wonder how long we can continue running up these trade deficits, because wealth is literally being drained from our country. Or is it?

In fact, is any part of the depressing result of trade deficits true, or is it logic gone awry?

The Defense

A sizeable number of economists, especially libertarian ones, actually defend trade deficits as good things. They base their argument on one made by an influential French economist of the 1800s named Frédéric Bastiat, who essentially said that if a company or other entity sells its products overseas and then buys lots of other products in that foreign land — products that are sold more inexpensively there than they are sold in the home country — the company or entity is not causing its home country or people hardship. In fact, he says, the home country benefits because its people are merely getting a really good deal in trade. For example, say Apple sells its iPhones in China, banking the money in the United States. Then if Apple workers and stockholders use the money to buy all manner of cheap Chinese products — oranges, fish, lamps, lightbulbs, shoes, etc. — Americans should celebrate their cheap buys.

In correspondence with this writer, economics professor Walter E. Williams was gracious enough to supply a succinct rationale for the line of thinking behind the defense of trade deficits:

Briefly: Say that a Japanese producer sells us a Toyota for $20K. If he just kept the money, it would be great for us. We’d have Japanese producers producing wonderful thing[s] for us in return for tiny slips of paper called dollars. If you accept that Japanese producers are not so stupid as to do that, and they don’t buy anything from us, then what? They might use those dollars to purchase something from an

India[n] producer. India[n] producers have no use for dollars except to use them to purchase something from maybe a German producer. The German producer might then purchase something from the U.S. The only reason anyone would take a dollar in return for goods is to ultimately have a claim on something produced in the U.S. That's unless you believe that foreigners just love to keep and look at the pictures of our former presidents on tiny slips of paper.

So under this theory, all the dollars Americans send abroad in trade eventually return to the United States to buy goods or services from Americans, unless foreigners are foolish enough to keep those little colored pieces of paper instead of redeeming them for American products. Either way, Americans win.

The trade-deficits-aren't-bad argument concludes that the economies of both countries involved in unequal trade benefit by the exchanges. In fact, under the theory, the country with the trade deficit probably is actually making out better in trade deals than the country or countries with which it trades: Not only did it get a very good deal in trade, but the country or countries trading with it will boost its economy by buying its products or stocks or bonds.

As has been said many times, "It sounds good in theory; how does it stand up to reality?"

Assumptions, Assumptions

Actually, there's good reason to see things this way — because trade deficits are *not necessarily bad*. As Professor Williams also has pointed out, very often what foreign entities do with the money Americans send them for products is buy stocks or bonds in the United States, strengthening segments of America, or they open businesses here, such as Toyota did in Huntsville, Alabama. As well, often trade deficits are accompanied by less unemployment, increased GDP, more manufacturing output, and lower poverty rates, as related by the Cato Institute's Daniel Griswold in his article "A Rising Trade Deficit Signals Good Times for U.S. Economy."

However, observation of the economies of the world shows that the theory doesn't stand up well under all conditions. It is only true under certain conditions.

Consider: If it is absolutely true that trade deficits don't matter, it must hold true, as well, that *any size trade deficit* doesn't matter — even to the point that a country can purchase all goods from abroad, without consequence. But there is a very obvious consequence to such a course, namely currency crashes — of which there have been 21 around the world in the past 25 years.

Of the 21 countries that caused hyperinflation of their currencies, 17 were running trade deficits at the time their currencies imploded. One of the remaining four, Brazil, had deficits leading up to the crash, but not in the year that rapid inflation began because of newly imposed import restrictions; and another, Zimbabwe, didn't have trade deficits until several years after inflation began in earnest, but its foreign trade did drop dramatically before then, leading to hyperinflation. Of the two remaining countries, Poland and Russia, there were other factors involved that had a similar effect on their economies as trade deficits: Poland had a trade surplus with Russia, but Russia only actually paid for a small fraction of the goods it imported from Poland because Russia was becoming insolvent as well.

In Russia, before its currency imploded, imports and exports usually balanced because the Western world didn't accept the ruble in trade — Russia needed to barter or use gold in trade with Westerners — but it still essentially ran deficits because in trade with the communist bloc, Russia often paid higher-than-world-market prices for goods it got from its trade partners in order to boost their failing economies. (For instance, Russia paid Cuba above-market prices for sugar.) Russia also gave direct aid to totalitarian governments so that they would follow Russia's foreign-policy lead.

Is it merely coincidence that countries that have hyperinflated their currencies had trade deficits, or is it a pattern signifying a link?

A currency hyperinflates when producers in a country can't produce enough goods — create enough wealth — to pay for government services, and the government decides to print money to pay for its employees and services. When people both at home and abroad realize that the currency produced by a country far outstrips the value of the saleable goods available in that country, price inflation runs rampant, and if enough money is printed, the currency can lose value rapidly, becoming virtually worthless. It is a truism that if a country purchased all goods from abroad, a country's currency would quickly devalue, providing a tie between trade deficits and currency crashes. (In truth, a country could provide services in exchange for goods, meaning a country would have to run a deficit in both goods and services to rapidly ruin its currency.) And hyperinflation often leads to pain for the people in those countries: starvation, rampant crime (post-crash in Russia, when criminals wanted something such as an apartment, the original owners often simply disappeared), lack of healthcare, etc., so trade deficits can definitely have downsides.

Also, if it is strictly true that trade deficits are good things, it follows, too, that every country with a trade deficit should benefit. And that's obviously not true. In fact, when Third World countries open their doors to imports, and the peoples in them are supplied with goods from abroad far cheaper than they could get the goods domestically, their local industries can be overwhelmed before they can compete in world markets, shutting them down. Hence, the open doors cause the countries to have few jobs, and the people continue to live in Third World conditions, often holding such livelihoods as growing gardens or herding cows and living in mud and stick huts.

Ironically, showing how open trade doors in Third World countries *doesn't work* is a case of generosity gone awry, as explained in the October 2011 article in *Foreign Policy* magazine entitled "Haiti Doesn't Need Your Old T-shirt." When Americans give their old clothes to a charity such as World Vision, the charity then gives the clothes away in Third World nations, putting the local industries out of business. Then the out-of-work residents can no longer afford to buy food or other necessities. The author explains:

World Vision, for example, spends 58 cents per shirt on shipping, warehousing, and distributing them, according to data reported by the blog *Aid Watch* — well within the range of what a secondhand shirt costs in a developing country. Bringing in shirts from outside also hurts the local economy: Garth Frazer of the University of Toronto estimates that increased used-clothing imports accounted for about half of the decline in apparel industry employment in Africa between 1981 and 2000. Want to really help a Zambian? Give him a shirt made in Zambia.

The article makes clear that people seldom starve or are malnourished in Third World countries because of a lack of available food; they go hungry because they cannot afford to buy the food.

Almost counter-intuitively, gifts of food also further impoverish the poor. When President Bill Clinton sent subsidized rice to Haiti, his actions wiped out thousands of local rice farmers who could no longer sell their produce (an action Clinton is said to have deemed one of his most grievous mistakes).

On the other hand, if a country has a trade deficit because it is buying production equipment so that it can soon produce items and run trade surpluses, a trade deficit could actually be a good thing. Take Malaysia as an example: In 1995, it had a worrisome trade deficit equal to nine percent of its gross national product, mainly as a result of importing capital goods for start-up enterprises. Since 1998, it has recorded consistent trade surpluses.

But back to trade deficits not mattering: If that theory is true, it also must hold true that no amount of interference by government against businesses in a country is really any problem at all — after all, under that theory, it is not a problem if a country is not producing much wealth to trade for the wealth of other countries. But again, this is obviously not true. In the end, too much interference leads to stifled business growth, leading to deficit spending and currency destruction, as communist countries have repeatedly demonstrated over the years. Again, Russia is a good example. Not only did centralized planning under communism cause the country to do foolish things that impoverished it, such as selling goods abroad more inexpensively than the products could be manufactured, hence causing an outflow of wealth, its disastrous transition to an allegedly more free economy was a textbook case of government interference in the economy. The February 2002 paper *Macroeconomics in Russia* released by the Graduate School of Business, University of Chicago lends some light to show how this happens:

Imagine for a moment that the Federal Reserve imposed the following policies in the United States: Every company must pay for all its inputs [raw materials, labor, and energy] before they are shipped, and taxes must also be prepaid. But there is no trade credit, and banks do not make working capital loans to purchase inputs. Checks take 90 days to clear, and companies cannot pay with cash to speed things up.

Chaos would result. The fall in output would dwarf the Great Depression. As symptoms, we would see desperate companies finding illicit ways to make and receive cash payments and circumvent regulations; we would see barter or "countertrade" deals; regulations aside, companies would have to tolerate massive unpaid bills.

This is roughly what happened in Russia during the summer of 1992.

It is a rule that the more totalitarian a government becomes, the more it will interfere in business and the greater the likelihood that the economy will slow dramatically. China is an excellent study in economic freedoms. Under strict communism, although China had lots of natural resources, its economy was stagnant, with most of the populace commuting via bicycle or foot, until it allowed Western investment. At the same time that Communist China withered, Hong Kong and Taiwan flourished, although both are inhabited by Chinese and have few natural resources. Venezuela's economy also imploded because of centralized planning, as did Vietnam's, Cambodia's, Cuba's, etc. — all totalitarian economies.

Fits by Fiat

The main problem with the Bastiat argument is that it doesn't do well at taking into consideration the medium of exchange — fiat currency, which is a currency not backed by a precious commodity, such as gold — or the actions of investors. If a country uses a fiat currency such as the American dollar, and it prints too much currency, people come to realize that the currency isn't worth the paper it's printed on, and the currency loses its value. And hyperinflation is brought on or exacerbated by trade deficits because deficits provide a major signal to investors to exit a particular country. Investors are exiting Singapore in droves right now based on its trade deficits. Though typically Singapore exports ample palm oil and coal, in recent months it has had large trade deficits, causing investors to flee, leading to funding problems for businesses and government alike.

Currency destruction has happened worldwide in the past, time and time again — even in the United States. At one time there was a saying in America, "not worth a Continental," which was a derisive reminder that the currency used during the Revolutionary War — the Continental — was overprinted and crashed, as did several currencies in the early colonies. Crashes have happened since the earliest recorded fiat currency was printed. China experienced repeated currency crashes from about 1150 A.D. to 1455 A.D., until China abandoned its paper money experiments and began using silver for currency.

To demonstrate why this is, let's take an extreme example: The U.S. government decides to make everyone rich and prints enough money to give each American $100 million. In the case of America, the government doesn't even need to print the money; it can merely make an electronic transaction, putting that much into every person's bank account. The result, of course, is not rich Americans; it is very expensive products in the marketplace. After the money transfer, people intuitively then know that the currency is not a good indicator of the country's assets and overall capital, and businesses raise the price of their goods. People realize that government has made a money transfer, not a wealth transfer.

For a real-life example, in Zimbabwe, after the government "redistributed" white-owned farms to blacks who didn't know how to farm, farm production and exports dropped, exports that had previously represented one-third of Zimbabwe's foreign-exchange earnings. Mining and manufacturing also dramatically slowed. Without enough wealth-creating products to sell abroad, the government began printing money to pay the military and government workers. People began to realize that too much money was being created, and price inflation went up from seven percent per year in 1980 to 79.6 billion percent per month in 2008. Before the government quit printing currency (now all transactions are done in foreign currencies), a loaf of bread might sell for billions in the local currency. It is worth repeating that Zimbabwe didn't actually incur a trade deficit until several years into its currency implosion, but its exports had declined considerably early on, meaning the government increasingly functioned by printing money.

The Zimbabwean example indicates a strong link between trade deficits and currency crashes: If a country continually falls well short of creating enough saleable goods to support government spending, and the government resorts to printing money to pay for spending, a currency crash is on the horizon — how far on the horizon depends on several factors, including how wealthy the country was to begin with.

The above example invalidates two of the suppositions that must be true if the Bastiat argument is infallibly correct: Government interference with businesses *did* negatively affect exports, and lowered exports *did* lead to currency insolvency. Finally, because the currency became insolvent, the people of the country were hurt drastically; they didn't benefit, as the theory suggests. As the *New York Times* quoted one Zimbabwean woman in 2008, "If you're not fit, you will starve." Nurses, janitors, garbage collectors, and others just quit showing up for work, devastating public health.

Currency destruction is a malady faced not just by Third World nations; Russia suffered from hyperinflation in the 1990s. Money that had been enough to buy a nice condo soon became only enough to buy a pair of boots.

A little analysis reveals why trade deficits and fiat currency don't generally mix well. Let's review: All wealth is created by taking advantage of things in the environment: farming, mining, drilling, fishing, ranching, logging, etc. Essentially a country gains wealth because it capitalizes on its natural resources, items available to it for free, so to speak — it still takes labor and capital, such as trucks, tractors, or oil rigs, to use the abundance to generate wealth, but it is there for the taking. Wealth can also be created by exploiting intellectual attributes. For instance, Apple exploits the minds of geniuses to create products that will help people work — or play — allowing Apple to demand lots of money for what are really inexpensive collections of wire and plastic. Other jobs or services, such as those services provided by government, do not create wealth; they either transfer wealth from one entity to another (from workers at a paper manufacturer to those at a latte stand) or they consume wealth (an Army division can burn 600,000 gallons of fuel per day).

Say that country "A" decides that it has enough wealth that no one in it ever need work again if they don't want to do so and that it can just print enough cash to pay for all goods and services — provided by country "B." Its experiment would start happily but end poorly. Country B would at first be likely to accept cash payments for goods and services from country A, for a while, because it could turn around and buy infrastructure and patents from country A, using the currency gained in trade with country A. Country B could also use A's money to buy goods and services it wanted from countries C through Z, because those countries could also use the cash to buy things from country A. But after a while, country A's strategy would fail because countries B through Z would find fewer and fewer companies or products that they really want to obtain from country A, and they would demand larger payments for goods and services that they provide so that they could, in effect, buy the rest of the things from country A — things that those countries really don't desire but would take if they got them cheaply enough. Soon country A would be bereft of jobs, factories, service industries, and other valuable possessions, and the people in it would be destitute and starving.

This extreme example also invalidates the Bastiat argument in another way: The Bastiat argument assumes that when a country such as the United States has a trade deficit abroad, foreign entities will turn around and buy goods from that country or invest in it. But if the foreigners essentially strip-mine wealth-producing businesses, leaving only government entities or personal service industries that don't create wealth, the trade deficits hurt the country because it's on its way to not producing enough wealth to pay to run the country, a la Zimbabwe. Note that foreigners don't need to take all of a country's industry to cause hyperinflation; they must take only enough so that the wealth produced in the country cannot possibly finance the government.

Finally, the Bastiat argument is found wanting in the claim that if foreigners hold onto U.S. currency, the United States really experiences a windfall because the foreigners are giving it tangible, valuable goods for worthless little pieces of colored paper.

Fiat currency is divorced from the laws of supply and demand. The value of the currency is really based on people's beliefs about how much value it holds, and this leads to currency disruption. Remember how the U.S. government's control over banks' interest rates, in combination with the Community Reinvestment Act, which made banks give home loans to people who likely couldn't pay them back, caused Americans' perceptions of house values to be faulty and caused a housing bubble, which popped in 2008, leading to economic malaise in this country. Similarly, people's perception of the value of a fiat currency can be manipulated for a time by government, but only for a matter of time.

If we acknowledge that ill-advised printing of fiat currency can cause great economic distress in a country, we are in essence acknowledging that large, continual trade deficits, funded with fiat currency, can be bad as well. If it *can be bad*, we then only need to determine if it is, in fact, bad.

America Is Not Immune

America is not immune from the consequences of continual trade deficits funded by fiat currency.

Since the U.S. dollar is the world's reserve fiat currency, peoples of the world actually do hold and store our little pieces of currency — not immediately laying claim to U.S. products — so that they can buy something in the United States in the future. They do this because they view the U.S. dollar as more likely to keep its value than other currencies. But the fact that foreigners hold our money isn't an unalloyed "good." Other countries, and foreigners in general, will hold these promissory notes only until the United States prints so many of them to pay its debts — debts that are caused to a large extent by trade deficits — that it becomes evident to the peoples of the world that if they wait to redeem the bills any longer, the promissory notes will become worthless. The bills will then be redeemed en masse, and their true worthless value realized — and prices will skyrocket.

In 2008, the United Nations estimated the total wealth of the United States, including human capital, to be $118 trillion, yet the country has unfunded future obligations somewhere between $125 and $225 trillion dollars. *If* the United States attempts to fund these obligations through selling debt or printing money, the country's future, and the future of everyone in it, will grow decidedly more bleak. This course has grown more likely by the Obama administration's implementation of the Foreign Account Tax Compliance Act, which is causing foreigners to disinvest in the U.S. corporations because they don't want to give the U.S. government access to all their financial data.

To put the situation of the United States in perspective, consider that in 2009, the Congressional Budget Office projected that by the year 2035, U.S. tax revenues will be able to pay only for Social Security, Medicare, Medicaid, and interest on the national debt. All other government spending — defense spending, outlays for federal prisons, federal employee payments (and retirement payments), and every other type of federal spending — will have to be paid for through borrowing from abroad (that's not going to happen) or printing currency.

In the meantime, because foreigners often already use their U.S. currency to buy U.S. companies and mineral rights, and transfer those entities and minerals to their own countries, they cause Americans to become unemployed, lowering the standard of living in the United States and speeding the dissolution of the dollar.

As well, when Chinese companies invest U.S. dollars in the United States by buying corporations or opening new businesses, those companies — which are likely *all controlled* by the communist government in China — will take their directives from the Communist Party and do their part to lobby and influence American politics and politicians to China's benefit and Americans' detriment — hardly a win-win situation.

To explain how trade deficits guide a country's path from riches to rags, one brief article about the crash of the Yugoslav economy, a March 2014 article by Predrag Rajsic of Mises Canada entitled "The Economy of Tito's Yugoslavia: Delaying the Inevitable Collapse," is very effective. It traces the consequences of Yugoslavia's trade deficits, explaining how they led to hyperinflation. It provides a good primer, and it even helps one determine if a country's trade deficit is a bad thing or not.

As to whether a trade deficit is bad or not, it posits, in short, that if an economy — including its trade balance — relies on increasing amounts of external debt to survive, its currency is doomed. The author recounts:

If the trade balance is positive, the country exports more than it imports, and we say that there is a trade surplus, and if the balance is negative, the imports are higher than exports and the country runs a trade deficit.

When the economy of a country is in a trade surplus, foreign currency (which the importers use to buy those exports) accumulates in the exporting country. On the other hand, [say] there is an outflow of foreign currency (used to pay for the imports) from a country whose economy is in a trade deficit. Countries that have [a] consistently negative trade balance must borrow from foreign lenders to compensate for the lack of foreign currency. It's not hard to see why this situation is unsustainable in the long run, that is, it is sustainable only as long as foreign creditors want to lend money to the debtor country.

The Mises rationale also allows room to make sense of why Daniel Griswold, mentioned earlier, of the Cato Institute found that when the United States was running trade deficits between the years 1973 and 1999, unemployment usually went down and GDP and manufacturing went up: Because the values of fiat currencies are not directly and immediately affected by the rules of supply and demand, a country can print and lend money and artificially stimulate segments of the economy for a while before the citizens notice the negative effects of the funny money. But just because citizens don't notice the effects in a dramatic way, such as happens when a currency implodes, that doesn't mean that bad effects aren't happening. During the time period of the Cato study, the cost of living in the United States — because the government printed additional money — was in the process of increasing so much that an average family could no longer live a middle-class life on the salary of just one wage earner; it became a country where two wages in a household went from a luxury to a virtual necessity. That's a heavy price to pay for small increases in employment and GDP.

Trade deficits affect a country's money creation (increasing it), which, in turn, affects citizens' cost of living (making it more expensive). And if the trade deficits are continued over time, they lead to currency destruction. So trade deficits do matter and they can definitely hurt — even in America.

The obvious solution to the problems caused by fiat currency and trade deficits is to get rid of fiat currency, but unfortunately, it's not that simple. The U.S. government also needs to dramatically reduce spending (spending money only on activities that are actually constitutional would enable that end) and stop loading up businesses with unnecessary and costly regulations.

It is likely that only then will America become a wealth-creating powerhouse with a stable currency.

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