THE FREEMAN
Ideas On Liberty
JUNE 2004

A Deficit of Understanding II

Writing in the January/February 2004 issue of *The Atlantic Monthly*, Sherle Schwenninger of the New America Foundation joined Warren Buffett and scores of politicians in bewailing America's trade deficit. Like his intellectual compatriots, Schwenninger simply assumes that the trade deficit is debt and that it's ominous. It is neither.

A trade deficit exists for the United States whenever Americans, during some period, import a greater dollar amount of goods and services than they export. This deficit means that some of the dollars which foreigners earn from selling things to American consumers are not spent during this same period buying things from American producers. This difference between the larger dollar-value of imports and the smaller dollar-value of exports is the trade deficit.

Whether or not all or part of this "deficit" *becomes* debt depends on what foreigners do with their dollars. If foreigners hold all their unspent dollars as cash reserves, none of the trade deficit becomes debt. Foreigners own some dollars while Americans own the goods and services they bought with this cash. Likewise, no debt is created if foreigners use their dollars to buy ownership shares in American companies or if they buy real estate in the United States.

Debt to foreigners is created only when Americans borrow from foreigners.

Donald Boudreaux (dboudrea@gmu.edu) is chairman of the economics department at George Mason University and former president of FEE.

It's true that Americans can and do borrow from foreigners. For example, Intel might borrow dollars from foreigners by selling bonds to them. Likewise, Uncle Sam might borrow dollars from foreigners by selling Treasury notes to them. In such cases, Americans do become indebted to foreigners—and, indeed, this indebtedness is facilitated by Americans running a trade deficit. But a trade deficit is not *necessarily* debt.

Let's suppose, though, that every last dollar of America's trade deficit does become debt. That is, suppose that if America's trade deficit is $500 billion, not a cent of this $500 billion owned by foreigners is held as cash reserves, and not a cent is used to buy American real estate or ownership shares in U.S. businesses. Instead, foreigners lend the money to Americans.

Should we worry?

One response is that foreigners who lend to Americans display confidence in the American economy. How many of us lend money to economically unpromising entities (who aren't our brothers-in-law)? To the extent that investor confidence drives the trade deficit, it should cause no concern.

Another response is that such loans strengthen the economy by enabling more productive investment to occur.

But insofar as America practices free trade, there's a more fundamental reason not to worry. An open economy is not defined by political borders. Therefore, measuring trade between people living in one particular space and people living in other spaces is misleading if these spaces are economically integrated.

Consider a straightforward example. Suppose you live in the only house on Elm Street, in the town of Townville. You're frugal; each month you save some of your income. Your financial future is bright because your sacrifices today will likely raise the value of your portfolio tomorrow. If we calculate the current account for Elm Street we will find that it is in surplus: you export more (in the form of supplying labor services to your employer) than you import (that is, than you consume).

Not-So-Frugal Neighbor

One day a house is built next to yours. Your new neighbor is a spendthrift; each month he not only spends all his income, but he also adds an amount of debt to his credit-card balance that exceeds the amount you save each month.

When we now calculate the current account for Elm Street, we find it to be in deficit. But are *you* worse off than before? No. Your rate of saving hasn't fallen. The fact that you live in an area that not only has a current-account deficit, but also where every cent of that deficit is in the form of debt does not worsen your economic prospects one bit. If you continue to save, you'll prosper.

Suppose that the issuer of your neighbor's credit card is First Townville Bank. Further suppose that this is the bank that holds your savings. First Townville Bank "imports" capital from you and "exports" capital to your neighbor. (The difference between the amounts borrowed and saved is made up through fractional-reserve banking.)

Now let's calculate the trade account for the entire town. If everyone else in Townville spends on consumption exactly the amount that he or she earns in income, and if First Townville Bank does business only with citizens of Townville, then Townville's current-account and capital-account both equal zero.

As this example shows, changing the geography over which we calculate trade accounts can generate significant changes in these calculations. If your house alone is reckoned as the relevant geographic unit, we find a current-account surplus; if both houses on Elm Street are reckoned as the relevant unit, we find a current-account deficit; if the entire town is reckoned as the relevant unit, we find that the current-account is neither in deficit nor surplus. Regardless of the way we choose to reckon, however, you are no better off or worse off.

The relevance of this example for the larger economy is obvious. To the extent that Americans trade freely with foreigners, Americans become integrated into an economy larger than that part of the North American landmass identified as "America." And it is this larger economy ("the global economy") that is most relevant.

Investment, of course, is desirable. And saving is necessary for investment. For a variety of reasons, much of the investment that today takes place within U.S. borders comes from the savings of non-Americans. But so what? If the research lab in Boston and the vineyard in Oregon are built with dollars borrowed from the Japanese, I and other Americans are no worse off or better off than if these productive assets were built with dollars borrowed from other Americans. I would likely be better off if I, too, saved more and invested in these assets. But whether or not I invest, the nationality of those who do invest is irrelevant to me and my economic prospects.

Opportunities for mutually advantageous trade are what matter. The greater the number of such opportunities, the better. Classifying the world's producers and consumers according to the issuer of their passports creates an illusion of relevance out of an utterly irrelevant happenstance. □