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A Deficit of Understanding

"Nothing, however, can be more absurd than this whole doctrine of the balance of trade."

—ADAM SMITH
The Wealth of Nations

Here's some sound advice: don't worry about the trade deficit.

The pundits' and politicians' hysteria over the trade deficit is rooted in confusion. The fact is, a trade deficit is unlikely to be a problem. Let's see why all the fuss about it is pointless.

Begin by recognizing that most people who haven't studied international economics don't know what the trade deficit is. The term itself is used on different occasions to refer to two different things. One is trade in merchandise. A country runs a deficit in merchandise trade if the dollar value of the tangible goods that it imports exceeds the dollar value of the tangible goods that it exports. But so what? Despite the fetish that many people have for manufacturing, there's nothing economically special about tangible goods and, hence, nothing meaningful about measurements of imports and exports of merchandise.

Consider two examples.

- Americans import $1 million of foreign cars and, in exchange, export to foreigners $1 million worth of software engineered in Silicon Valley. The software is delivered to foreigners by loading it onto computer diskettes and then shipping these diskettes abroad.
- Americans import $1 million of foreign cars and, in exchange, export to foreigners $1 million worth of software engineered in Silicon Valley. The software is delivered to foreigners by having them download it online.

Economically, no relevant difference separates these two examples. In both, foreigners use their dollars to buy American software-engineering services. But while in the first example America's merchandise-trade account is balanced, in the second, America has a merchandise-trade deficit.

A measurement so sensitive to such economically irrelevant factors as the *form* taken by exports and imports is unworthy of serious attention.

A better trade-measurement figure is the current account, which measures trade in goods *and* services. Not incidentally, the current account is balanced in both of the above examples.

Nevertheless, the picture of international trade offered by the current account is incomplete. As its name suggests, it excludes

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investment decisions. These are made principally with a view to future periods, not just the current one. International investments, therefore, are measured in a different account, the capital account.

What can a foreigner do with dollars he earns from selling something to Americans? He can spend them on U.S.-made goods or services. If he does so, America's current account moves closer into balance. But he often invests his dollars. He can buy stock in American corporations, U.S. Treasury notes, Texas real estate, and so on.

If he invests his dollars, he contributes to an American current-account deficit. Importantly, however, he also contributes to an American capital-account surplus.

Accounts Cancel Out

The accounting rules that govern the computation of the capital and current accounts guarantee that, in economies with floating exchange rates, these two accounts cancel each other out. They are *defined* so that, together, they add up to zero.

For example, if the U.S. current account is in a deficit of $138,671,255,142, then the U.S. capital account is in a surplus of $138,671,255,142. Keep this fact in mind when you next hear a network anchorman bemoan the size of "the" trade deficit. He could just as truthfully report on the size of "the" surplus.

Several other features are worth noting about a capital-account surplus (or current-account deficit).

First, a larger U.S. capital-account surplus generally means brighter U.S. economic prospects. Not only is large and growing foreign investment in the United States evidence that investors worldwide believe the American economy's prospects to be rosy, but also the inflow of investment funds creates valuable assets, such as more machines, more factories, and increased research and development. This raises the productivity of labor (causing wages to rise), improves work conditions, and generates greater output. Americans' standard of living increases.

To press for reducing America's current-account deficit is to press for reducing the capital-account surplus—which, if achieved through protectionist measures, will mean reduced investment in the U.S. economy. That's no recipe for enhancing the prospects of American workers and consumers.

A second fact is that, despite the assertions of Warren Buffett and a herd of politicians, a trade deficit is not a species of debt.

I'm writing this column on a Sony computer. I bought the computer outright from Sony (a Japanese company) with dollars that I earned from working. I now own a valuable computer; Sony now owns more dollars. No debt was created in this transaction.

Whether or not Americans become indebted to Sony as a consequence of this transaction depends on how Sony and Americans afterward choose to interact commercially with each other. Sony can spend its dollars in countless other ways that both increase America's current-account deficit *and* create no debt owed by Americans to foreigners.

If Sony buys shares in Microsoft, no debt is created, even though this series of transactions raises the U.S. current-account deficit. Likewise if Sony uses these dollars to purchase American real estate, or if Sony holds its dollars as cash reserves.

Debt enters this picture only if Sony uses its dollars to buy corporate or government bonds. Bonds, of course, are I.O.U.s.

Even when foreigners spend all their dollars on American debt instruments—that is, loan their dollars to Americans—nothing is necessarily amiss. Americans issuing the bonds do so voluntarily, and foreigners buying the bonds do so voluntarily.

Whether or not such indebtedness is good or bad depends on a variety of factors, none of which is the nationality of the lender. In my next column, I explain why. □