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Continuing the Conversation on Free Trade

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My previous posts on free trade opened a lively conversation among readers on its pros and cons. Today I'd like to wrap up these exchanges with a coda.

Public discussions on foreign trade sometimes convey the impression that China and the rest of the world make everything, as the United States sits idly by, importing their stuff and going to hell in a handbasket, to use the vernacular.

The chart below demonstrates that this is simply not so. Goods and services produced here still represent the great bulk of gross domestic product in the United States.

Economic Report of the President 2011, Table B-1

Our gross domestic product consists of:

1. spending by American consumers on goods and services produced in the United States and abroad (70.8 percent of G.D.P.)

2. government spending in the United States, at all levels, on goods and services produced in the United States and abroad, excluding government transfer payments (20.6 percent)

3. spending by American companies on equipment, structures and inventories and by American households on residential construction, some of which may be on foreign-produced goods and services, lumped together as gross private investment (11.3 percent)

4. American exports – that is, spending by foreigners on goods and services produced in the United States (11.2 percent)

From which we then subtract imports – that is, spending by Americans on foreign-produced goods and services (13.9 percent).

Imports are subtracted because they are contained in the other spending categories and do not represent goods and services produced in the United States. Without subtracting spending on imports, one would overstate gross domestic product by close to 14 percent.

What is often overlooked in our debate on foreign trade is that American exports – about $1.6 trillion in 2009 — create millions of jobs for Americans. That is part of the foreign-trade picture, too.

To be sure, American imports in the last several decades have tended to exceed American exports. The difference between these is called net exports. They are positive when exports exceed imports, and negative when the opposite is the case.

As the next chart shows, net exports were positive in the 1960s to the mid-1970s, when much of the world was still recovering from World War II or was highly underdeveloped. As the rest of the world sought to catch up with the United States, net exports turned negative — in some years (2005-6), close to 6 percent of gross domestic product.

Economic Report of the President, 2011, Table B-1

In plain English, Americans have become used to spending more on themselves than their own gross domestic product year after year and enjoying themselves as they've done that.

When net exports are negative, how do Americans pay for the excess imports?

Ultimately, they pay with financial paper, namely, I.O.U.'s in the form of Treasury bonds, corporate bonds sold to foreigners, ownership claims on American corporations (stock certificates) or legal titles to real estate sold to foreigners.

Americans have taken full advantage of this external financing facility in the last several decades. Until about 2008, American households saved less and less of their disposable income, falling to 1 percent of gross domestic product by 2006, although recovering somewhat thereafter (see next chart).

Economic Report of the President 2011, Table B-32

Through the politicians they have elected, Americans have granted themselves a series of generous tax cuts, all the while driving up government spending. Unable to finance the resulting federal deficits fully from domestic savings, borrowing from foreigners, as described above, was used to fill the gap.

Thus, the much lamented trade deficit — more accurately, the current account deficit — enabled Americans to spend more than their own gross domestic product.

The tax-cut theme still sells well among the electorate and undoubtedly will be dangled before voters again in 2012, abetted no doubt by some economists, while even cuts of $100 billion (or about 2.5 percent) of a federal budget of close to $4 trillion face serious political hurdles.

Home-grown fiscal mismanagement at many levels, however, does not make the case against the benefits of free trade. It merely cries out for more responsible fiscal management at home –- which, at some point, might come. In principle, a nation can both be fiscally responsible and enjoy the overall benefits of free trade.

As I noted several weeks ago, the basic proposition of economists on free trade is:

Relative to a status quo of no or limited international trade, permitting full free trade across borders will leave in its wake some immediate losers, but citizens who gain from such trade gain much more than the losers lose. On a net basis, therefore, each nation gains over all from such trade.

Many of those who commented on my previous posts did not dispute this proposition, which is, in fact, hard to dispute either at the theoretical or empirical level. Rather, these readers note, the main problem with free trade is that many countries merely pay lip service to its principles but breach them through a variety of trade restrictions.

In this regard the United States is not, of course, exactly a saint, especially in agriculture. A glaring example is the American quota on sugar imports with a truly dubious –- one might even say ugly –- redistribution of income. And as the libertarian Cato Institute has remarked, even President Reagan, widely thought of as a devoted free trader, often enacted or supported protectionist policies.

Criticism of unfair trade restrictions do have validity, especially in periods of global recession, during which trade restrictions imposed by one nation can help it export its unemployment to other nations. The proper policy response to trade barriers, however, is not the abandonment of free trade but efforts to eliminate these barriers.

After all, imagine what life would be like in the United States in the absence of foreign trade, with all products we use daily made domestically –- many would be far more expensive than they currently are, and many would be likely to be of inferior quality to those now available.

One can only imagine what American cars would be like if domestic auto makers had not been exposed to stiff price- and quality competition from Europe and Asia.

Most of those who commented on my posts did recognize that a liberalization of foreign trade, while it is beneficial over all to a nation, can lead to significant redistributions of economic privilege within that overall national benefit. That is a valid concern, which naturally pushes the issue into the political forum.

My argument is that economists, in making the case for free trade, should be more understanding of this political dimension than they often are. That might make their message more effective.

In making their case, economists can, of course, point out that international trade is not the only and probably not the major source of economic disruptions in a dynamic economy. The renowned economist Joseph Alois Schumpeter viewed such disruptions as an outcome of the process of "creative destruction" in a dynamic economy.

The question is whether those who gain from what we celebrate as "disruptive innovations" owe the losers compensation for their loss.

Suppose the Jones family is hurt financially by low-cost imports from abroad, while the Smith family is hurt equally by home-grown disruptive innovation – such as the displacement of travel agents by online booking of airlines and hotels or of airline ticket-counter personnel by online check-in. Should only the Jones family be compensated for its loss because it involves foreign trade?

A far better approach would be to have in place a solid, general economic safety net that helps all families whose economic base is disrupted through forces beyond their control, whether such disruptions originate in foreign trade or domestic developments.

Unfortunately, too many economists decry that approach as a welfare state –- and that makes selling the case for free trade that much harder.