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Two Cheers for A Big U.S. Trade Deficit

David Bier and Ivan Osorio, of the Competitive Enterprise Institute, say there's nothing to fear about trade imbalances.

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News that the U.S. trade deficit narrowed this summer has brought the usual cheers from commentators. The Associated Press celebrated, noting, "[A] narrowing trade deficit adds to economic growth." Bloomberg News called the smaller trade gap a "boost to the economy." Meanwhile, opponents of pending free trade agreements with South Korea, Panama and Colombia claim that the trade deficit is still too large and the trade deals should be abandoned.

But the truth is there's nothing to fear about trade imbalances. They only mean more investment in U.S. industries and businesses.

While a "deficit" in trade sounds bad, no real deficit exists. Most trade statistics simply fail to account for foreign investment. Foreign investors do not sit on their dollars. If they do not buy American goods and services, they invest in dollar-denominated assets like stocks and bonds, real estate, or even government debt.

The trade deficit has helped the U.S. maintain the highest level of foreign direct investment in the world by far. In 2010, foreigners invested almost $2.6 trillion in U.S. banks, businesses, real estate and, to a lesser extent, the government — more than 4.5 times the level of foreign investment in China last year. Companies invest this foreign capital in research and development, factories, and workers. This creates new wealth and jobs, driving economic growth and raising living standards.

Trade imbalances don't harm the economy. Lower trade deficits have accompanied low levels of economic growth. During the Great Depression, for example, the U.S. actually ran trade surpluses every year. By contrast, real GDP since 1980 grew 3.5 times faster when the deficit rose than when it declined, as a study by the Cato Institute notes. Over the same period, employment, manufacturing, and the stock market all also increased the fastest alongside a widening trade gap.

Phony fears over trade deficits lead to phony "solutions" that end up doing harm.

Protectionists who harp on trade deficit fears often propose to subsidize exports, restrict imports, or both. These proposals are bad ideas. Tariffs and quotas keep inexpensive foreign goods out, driving up prices for consumers and costs for businesses. In response to the U.S. import restrictions (and domestic price supports) for sugar, for example, candy makers like Hershey and Lifesavers were forced to lay off American workers and move their operations outside the U.S.

Bush-era trade quotas on steel demonstrate a secondary effect of trade restrictions. The quotas raised steel prices by almost 30% in the United States, which forced the U.S. container industry to close factories and cut jobs. And, as the container industry bought less steel from abroad, overseas firms had fewer dollars to buy U.S. products or to invest in the U.S. economy. This damages all aspects of the economy — including exports, the very thing protectionists say they want to encourage.

Export subsidies make taxpayers incur the higher costs for goods consumers would not otherwise have purchased. While American car manufacturers like General Motors and Chrysler benefit from subsidies, American consumers who incur the costs through taxes have less money for other products, which hurts the general economy.

Two other effects of subsidies are also overlooked. First, subsidies that keep inefficient companies afloat prevent businessmen, workers, and capital from relocating to other industries (or from creating new industries) where they could better serve consumers. GM workers, engineers and CEOs might put their skills to better use at other car firms, making airplanes, or starting entirely new companies.

Second, subsidies indirectly hurt exports and foreign investment. Subsidies for GM and Chrysler keep consumers from buying as many foreign cars, so Koreans, Germans, and Japanese have fewer dollars to buy U.S. products and invest in U.S. companies. Less investment means less competitive companies, which also means fewer exports.

Congress and the president have many problems they need to address, but the trade deficit is not one of them. Rep. Dennis Kucinich and others in Congress are making a lot of noise opposing the pending free trade agreements with Colombia, South Korea, and Panama, citing fears about America's trade deficit. Such protectionist voices are wrong. Imports, as much as exports, are good for American jobs and prosperity.