America's Trade Deficit Is, Too, Real Money

I noted in a previous post how the level of America's industrial output cannot possibly be healthy if it causes us to run a trade deficit with other nations. So yes, we really do have a sickly manufacturing sector on our hands.
This has provoked a flurry of complaints about how trade deficits don't really matter.
This is a familiar line, especially from libertarian economists like Dan Griswold of the Cato Institute, who referred to the trade deficit as an "accounting abstraction" in his recent book defending free trade.

For a start, this is a silly way to characterize anything with a dollar sign in front of it, simply because all numbers in economics are, in some sense, accounting abstractions. Numbers are an abstract measure of things in the real world, including wealth, and the trade deficit is no different. By that standard, being a millionaire is an "accounting abstraction." So is being insolvent. A number on a ledger is not a loaf of bread, a car, or a bar of gold.

More fundamentally, the idea that the deficit is just an abstraction is identical to the seductive idea that trade deficits *somehow don't represent real money*. We measure the deficit in dollars, but somehow these aren't "real" dollars, not dollars that anyone ever had to earn, or pay back, or could spend. They're a kind of magic money, as unreal as the values of bubble-inflated securities before the financial crash. They're postmodern, unreal, virtual, *free*.
So let's get back to first principles and carefully review why America's trade deficit represents real money and is therefore a real problem.

To understand trade deficits, just think through the logic below, step-by-step:

Step 1) **Nations engage in trade.** So Americans sell people in other nations goods and buy goods in return. ("Goods" in this context means not just physical objects but also services.)
Step 2) **One cannot get goods for free.** So when Americans buy goods from foreigners, we have to give them something in return.
Step 3) **There are only three things we can give in return.**
3a) Goods we produce today.
3b) Goods we produced yesterday.
3c) Goods we will produce tomorrow.
This list is exhaustive. If a fourth alternative exists, then we must be trading with Santa Claus, because we are getting goods for nothing. Here's what 3a) -3c) above mean concretely:

3a) is when we sell foreigners jet airplanes.
3b) is when we sell foreigners American office buildings.
3c) is when we go into debt to foreigners.

3b) and 3c) happen when America runs a trade deficit. Because we are not covering the value of our imports with 3a) the value of our exports, we must make up the difference by either 3b) selling assets or 3c) assuming debt.

If either is happening, America is either gradually being sold off to foreigners or gradually sinking into debt to them. Xenophobia is not necessary for this to be a bad thing, only bookkeeping: Americans are poorer simply because we own less and owe more. Our net worth is lower.

This situation is also unsustainable. We have only so many existing assets we can sell off, and we can afford to service only so much debt. By contrast, we can produce goods indefinitely. So deficit trade, if it goes on year after year, must eventually be curtailed -- which will mean reducing our consumption.

Even worse, deficit trade also destroys jobs *right now*. In 3a), when we export jets, this means we must employ people to produce them, and we can afford to because selling the jets brings in money to pay their salaries. But in 3b), those office buildings have already been built (possibly decades ago), so no jobs *today* are created by selling them. And in 3c), no jobs are created today because the goods are promised for the future. While jobs will be created *then* to produce these goods, the wages of these future jobs will be paid by us, not by foreigners. Because the foreigners *already* gave us their goods, back when we bought from them on credit, they won't owe us anything later. So we will be required, in effect, to work without being paid.
The above facts are all precisely what we should expect, simply on the basis of common sense, as there is no something-for-nothing in this world. And that is what the idea that trade deficits don't matter ultimately amounts to. There do exist, however, ways of shifting consumption forwards and backwards in time, which can certainly create the illusion of something for nothing for a while. This illusion is dangerous precisely because the complexities of modern finance, and the profitability of playing along with the illusion while it lasts, both tend to disguise the reality.

Most of these complexities amount to ways of claiming that the wonders of modern finance enable us either to borrow or sell assets indefinitely. But as long as one bears the above reasoning firmly in mind, it should be obvious why none of these schemes can possibly work, even without unraveling their details. These financial fairy tales usually boil down to the fact that a financial bubble, by inflating asset prices seemingly without limit, can for a period of time make it seem as if a nation has an infinite supply of assets appearing magically out of thin air. (Or a finite supply of assets whose value keeps going up and up.) These assets can then be sold to foreigners. And because debt can be secured against these assets, debt works the same way.

But, of course, as America learned in the recent financial crisis, you can't cheat reality forever. There is no free lunch (one of the few points on which I agree with Milton Friedman), and yes, trade deficits are real money. And I'm happy to bet 1,000 units of accounting abstraction with anyone who believes otherwise.