

# 1. Why Trade Deficits Matter

*Once when Jacob was cooking a stew, Esau came in from the open, famished. And Esau said to Jacob, "Give me some of that red stuff to gulp down, for I am famished."... Jacob said, "First sell me your birthright." And Esau said, "I am at the point of death, so what use is my birthright to me?" But Jacob said, "Swear to me first." So he swore to him, and sold his birthright to Jacob. Jacob then gave Esau bread and lentil stew; he ate and drank, and he rose and went away. Thus did Esau spurn his birthright.*

-Genesis, Chapter 25, JPS translation

Our focus in this chapter is on the growing problem posed by the trade deficits. In the short term, the trade deficit is deindustrializing the United States while allowing some US residents to enjoy extraordinarily high living standards that are not justified by American productivity. In the long term, the trade deficit is not sustainable. It will likely lead to the collapse of the dollar, depression, and conversion of the United States to a second-rate power.

Not only will the United States feel the pain, but other countries will as well. Because other countries are dependant upon the US dollar as a reserve currency and because they are dependent on exports to the United States to sustain their own economies, the eventual collapse of the dollar could wreak havoc on the economies of the whole world.

Trade deficits cannot occur unless foreign governments or private investors are willing to finance them. There must always be a balance of payments. Deficits on trade and services have to be made up through a countervailing flow of funds. Indeed, the flow comes first because importers have to be sure of funds to purchase goods abroad. That flow of funds can sometimes include gifts, but it is usually made up of loans. When there is a trade deficit there is an equivalent flow of foreign savings in the opposite direction. In this book we will use "foreign savings" and "foreign financial capital" to refer to the flow of funds into the United States that finances the US trade deficits.

These inflows caused the dollar to rise to an artificially high level in

2002 as compared to a broad index of other currencies (an index calculated by the Federal Reserve). The high value of the dollar kept foreign goods cheap and stimulated US imports. It kept American goods expensive and discouraged US exports.

Normally, trade deficits are self-correcting. When a country begins to run a trade deficit, its currency declines in price in world currency markets. This makes its goods less expensive and foreign goods more expensive. But several of our trading partners, including Japan and China, manipulate currency values, keeping the American dollar overvalued relative to their own currencies in order to perpetuate and grow our trade deficits with them. They do this by sending the excess of dollars they earn back to us, by buying US government bonds and other US assets, in effect lending us the money to buy their goods. The Japanese and Chinese governments account for about two-thirds of the foreign-government-caused component of the trade deficits.

#### **WHY BALANCED FREE TRADE SHOULD BE OUR GOAL**

Are trade deficits a problem? Some economists are flippant. Why would a country want to exchange goods of greater value than it receives? And if a country willingly sends you goods of greater value than you send it, what is your complaint? Because most economists believe that trade deficits are a short-term phenomenon, their analysis of the costs and benefits of trade deficits has been restricted. In the short term, the country running a deficit benefits from higher consumption than would otherwise be possible, and the country exporting more than it imports consumes less than it otherwise would. But there are long term costs to accepting long-term trade deficits.

There are economic models which show that in the long run the situation reverses, with the country that “gave away” goods in exchange for IOUs better off, and the country which accepted the “free” goods worse off. A minimum standard for ensuring that trade does benefit all is that trade should be relatively in balance.

When trade is in balance, all countries benefit. Each country specializes in what it does best; exchanging those products for products it could not produce as cheaply as the selling country. As a result of such specialization, each country is enabled to use or consume a greater

quantity of goods and services than it would have been able to do in the absence of trade. Classical economist David Ricardo in 1821 summarized the case for free trade as follows:

Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each. This pursuit of individual advantage is admirably connected with the universal good of the whole. By stimulating industry, by rewarding ingenuity, and by using most efficaciously the peculiar powers bestowed by nature, it distributes labour most effectively and most economically: while, by increasing the general mass of productions, it diffuses general benefit, and binds together, by one common tie of interest and intercourse, the universal society of nations throughout the civilized world. It is this principle which determines that wine shall be made in France and Portugal, that corn shall be grown in America and Poland, and that hardware and other goods shall be manufactured in England.<sup>1</sup>

The advantages of international trade based on comparative advantage have long been clear. Each country specializes in what it can produce most efficiently and exchanges those goods for goods other countries produce more efficiently. When trade is in balance, both countries enjoy higher standards of living. Each country gives up a bundle of goods it can produce more efficiently for a bundle of goods the other country produces more efficiently. This raises the living standards of workers in both countries.

In this context, government interventions that distort market incentives are unambiguously bad. For instance, a tariff that limits trade would prevent otherwise beneficial exchanges from taking place and this would make both countries worse off than they otherwise would be. By the same token, an export subsidy that encourages trade would merely shift prices downwards on the subsidized good, giving a free benefit to those receiving the good.

Note that Ricardo assumes that trade is in balance. Therefore, the losses to those who lose their jobs as a result of being displaced by imports are more than offset by gains to those who produce for ex-

port. In addition, the standard of living in each country is raised.

Ricardo's comparative advantage argument leaves little room for chronically imbalanced trade, and no reason for it to persist. From this perspective, imbalanced trade is akin to a failure of supply to meet demand. It is analogous to a store stocking more goods than it can sell. Eventually prices will adjust, and balance will be restored.

For more than two centuries, the leading economists believed that an optimum trade balance would be produced by a policy of free trade. They even rationalized it by developing a theory that if all countries were on the gold standard (each currency convertible to gold at a specified weight), market forces would automatically cause prices to fall in the trade deficit country and rise in the trade surplus country and thus restore the balance of trade. They reasoned that the export of gold in settlement of the trade imbalance would force a reduction in the money supply in the deficit country causing wages and prices to fall and vice versa in the surplus country. In 1935, however, John Maynard Keynes argued that wages and prices were relatively inflexible and predicted, on that basis, that the adjustment in the deficit country would be accompanied by widespread unemployment and depression.

In 1972, the United States, faced with the loss of gold reserves, went off the gold standard and was followed by the rest of the world adopting the current system of flexible exchange rates. Economists believed that under a system of flexible exchange rates, the currency of any country experiencing substantial trade deficits would decline relative to the currencies of the trade surplus countries. This would make imports more expensive in the country experiencing the trade deficits, reducing its demand for imports, and make its exports less expensive to foreigners, increasing their demand for its exports. Over time, at least, balanced trade and purchasing power parity would be maintained. The only problem with this argument is that it has empirical holes. Why has the US trade deficit persisted for more than two decades? What delayed the natural adjustment? Enter strategic trade theory and the currency manipulations of the dollar mercantilist nations.

**“Strategic Trade” versus Free Trade**

In modern economic theory, the classical comparative advantage justification for free trade has been complicated by other factors. It is no longer considered to be a complete treatment of the topic. As Paul Krugman wrote in 1987:

Free trade is not *passé*, but it is an idea that has irretrievably lost its innocence. Its status has shifted from optimum to reasonable rule of thumb. There is still a case for free trade as a good policy, and as a useful target in the practical world of politics, but it can never again be asserted as the policy that economic theory tells us is always right.<sup>2</sup>

There are a series of “what if” questions that the classic comparative advantage story does not address. As economists have addressed these questions, the case for free trade has become more complex, and imbalanced trade has become a more obvious problem.

The classic model assumes that comparative advantage is fixed. This makes sense when it comes to comparative advantage derived from natural resources but makes much less sense for complex manufactured goods. What if, by contrast, comparative advantage develops over time as firms learn how to produce goods more effectively? The classic model assumes that markets are perfectly competitive. What if they are not? What if the assumption that trade must balance is modified to allow the accumulation of debt and financial assets?

The consequence of asking these questions has been a set of “if” statements. As Harry Truman famously complained, most economists have two hands, and are likely to say “on the one hand... but on the other hand...” If certain conditions apply, then free trade remains optimal (or at least appealing). If other conditions apply, then governments have an incentive to engage in “strategic trade” policies that subsidize exporters, protect domestic markets, etc., in order to alter the terms of trade in favor of the domestic economy.<sup>3</sup> In other words, some of the time, non-free-trade or “strategic trade” policies allow governments to boost the national economy. Typically, though not always, this gain is at the expense of other national economies.<sup>4</sup>

What kinds of costs are imposed? One version of the strategic trade model focuses on competition between firms in two countries to make sales to a third country. Because the market is not perfectly competitive, there are oligopoly profits to be made by the firm that makes the sale. If one country can distort the terms of competition (e.g., through a subsidy to its exporters or by driving up the value of the currency of the other country), it can drive the other country out of the market, and realize the profits all by itself.<sup>5</sup>

Another way of characterizing the case for strategic trade builds on ideas of “external economies,” because there are almost always “knowledge spillovers.” For instance, getting better at making computers has allowed the Chinese government to get better at making weapons much more rapidly. Subsidizing one industry can have payoffs for other industries.<sup>6</sup>

The simplest case, however, is one that focuses on just two countries and monetary mercantilism. The mercantilist country runs a surplus for a while with the target country and invests the surplus received from trade in income-producing assets of the target country. Eventually the mercantilist country has substantially higher consumption because it is able to spend some of the profits from the foreign investment on consumables. The target country, eventually, has a lower level of consumption because it is paying for the mercantilists’ consumption.<sup>7</sup>

Although strategic trade writers eschew the term, their analyses suggest that mercantilist policies can pay off. Contrary to the classic comparative advantage analysis, beggaring-thy-neighbor is often in the national interest. As Paul Krugman and other authors in the strategic trade literature note, these theories can be (mis)read as giving the green light to mercantilism.

### **Mercantilism and Imbalanced Trade**

Mercantilism was an economic philosophy that dominated government policies from the sixteenth to the eighteenth centuries. It equated a country’s welfare with an increase in its stock of gold and treasure. To a large extent, this was the result of the discovery of Aztec gold in the new world. Spain prospered by the shipment of

treasure from the new world and became the dominant world power. The evidence thus appeared to justify the mercantilist view that equated gold and treasure with national power.

The mercantilist countries of the 16<sup>th</sup> through 19<sup>th</sup> centuries sought to export more than they imported in order to build up their gold hoards. During the sixteenth century, the Spanish gold taken from its American colonies was used to pay for goods made in England, France, and other countries. England and France grew economically while Spanish industry foundered, leaving Spain a second rate power.

The beginnings of economics as a science is often dated from the publication in 1776 of Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* in which he criticized the underlying concept behind mercantilism. A nation's wealth, he argued, was not its gold, but its product. Smith was correct. The Spanish were clearly wrong to think that stolen gold would produce any long-term benefit. But the British and other mercantilist countries were not completely wrong. By building up their industries at Spanish expense, they turned themselves into economic superpowers and brought down the power of their military rival.

Mercantilism is a beggar-thy-neighbor trade policy. From the standpoint of the world economy as a whole, free trade is a far better policy. After Smith, removing any and all barriers to exports and imports became one of the first great "scientific" economic policies because it was shown that all parties benefited from trade.

Our problem is that the United States is currently the country being beggared. Strategic trade of various types can lead to real long-term changes in US competitiveness. Recent economic rethinking of the theory of international trade reveals that mercantilism can succeed in raising the long-term standard of living of those in countries practicing it.

The United States experienced chronic trade deficits for the past three decades, but the dollar did not fall relative to the currencies of the trade surplus countries. Economists, having raised free trade to a dogma, never counted on countries deliberately accumulating dollar reserves and dollar assets in order to manipulate currency values so

as to maintain their favorable trade balances (dollar mercantilism). They also never counted on countries introducing policies, as the US government has done, that subsidize foreign savings over domestic savings. By investing their trade surpluses in US assets, Japan, China, South Korea, and several other countries are preventing any correction to the trade imbalance. The result: chronic trade deficits in the United States.

Are those who run chronic trade surpluses with the United States gaining anything thereby? In the old days of gold mercantilism, the gold gained from trade circulated as money. In the new days of dollar mercantilism, the dollars that are “sterilized” from trade are loaned back to the United States and earn interest. As a result, the dollar mercantilist nations earn income on their US investments so long as the dollars they acquire retain value.

The classic model assumed away trade deficits and surpluses. However in 1997, Peking University economics professor Heng-Fu Zou, a Senior Research Economist for the World Bank’s Development Research Group, showed, in an intriguing paper, that mercantilism can succeed on its own terms for a small economy. Accumulating foreign assets (running a trade surplus) leads to long term positive outcomes. “A nation with strong mercantilist sentiment ends up with large foreign asset accumulation and high consumption in the long run.”<sup>8</sup>

Zou’s paper has been almost entirely ignored by the profession. It runs contrary to the received wisdom. But its intuition is very simple. A mercantilist preference for asset accumulation has the effect of increasing future consumption. By saving more now, countries put themselves in the position of collecting additional interest and other income later. This can make their consumers better off in the long term. In addition to the normal gains from specialization and comparative advantage, they will also be able to consume profits from their savings. Other studies of the history of recent Asian mercantilism reach similar conclusions: mercantilism can pay off.<sup>9</sup> The principal neighbor being beggared by this beggar-thy-neighbor approach to trade policy is the United States, soothed into passivity by the enjoyment of cheap imported goods bought with borrowed cash.

There are other important long-term advantages that accrue to countries with chronic trade surpluses. What they lose in short-term consumption, they may, under some circumstances, regain in long term technological advantage. By strengthening their industry and undermining US industry, they enhance their economic power in the world. These countries sacrifice some domestic consumption in the short-term, but gain tremendously in terms of long-term growth. In contrast, the United States gains domestic consumption in the short term, but suffers deindustrialization and, eventually, a severe cut in living standards.

Relatively balanced trade is a necessary precondition for the full benefits of free trade. When trade is in balance, the gains of those in the export industries plus the gains that consumers get from lower prices exceed the losses of those in the industries adversely affected by imports. Workers who lose jobs in low-wage industries that compete with imports find better-paying jobs in expanding export-oriented industries. But when a country experiences growing and chronic trade deficits as the United States has done for three decades, good jobs and rising wages are created in the exporting countries while in the United States manufacturing workers lose their jobs and are forced to seek jobs in the service sector, putting downward pressure on wages. The damage done by the deficits is not that they caused unemployment but that they caused wages to stagnate and made the distribution of income more unequal. Had exports increased in proportion to imports, the workers who lost jobs in low-wage industries like textiles and shoes would have found more productive and better-paying jobs in expanding export-oriented companies like Deere and Boeing.

There are substantial and real advantages to free trade, but mercantilist or strategic trade policies can benefit US trading partners while hurting the US economy. If strategic/mercantilist policies were succeeding, we would observe precisely what we are observing: large chronic trade deficits and the destruction of US competitive advantage in industry after industry.

When US policy makers believe in free trade induces many to main-

tain that all is well, we risk undermining the conditions under which free trade can succeed. In an analysis of the strategic trade model, David Collie demonstrated that free trade can be sustained under only some assumptions about relative competitiveness, and in these circumstances free trade is sustained with the threat of a trade war.<sup>10</sup>

Other studies affirm this point in models that overcome the original theoretical conflicts of the strategic trade literature concerning Cournot versus Bertrand competition. Efforts to distort the terms of trade strategically can succeed in boosting national income only when other nations do not respond. Beggaring thy neighbor can work, but only if the neighbor is passive.<sup>11</sup>

By ignoring strategic manipulation of the terms of trade by our more mercantilist trading partners, the United States may create conditions in which strategic trade and mercantilism rather than free trade are in equilibrium for those countries. *We are trading away our future for a mess of mercantilist produced pottage!*

#### EFFECT ON MANUFACTURING

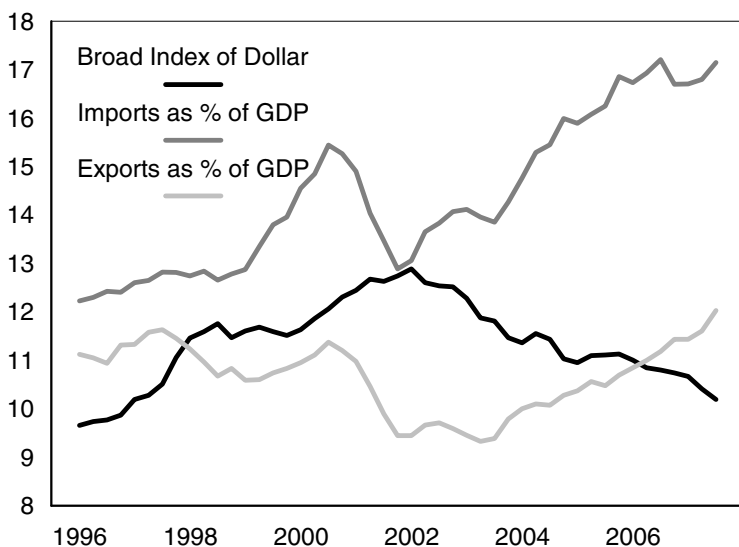
There are many products involved in international trade. These include manufactured goods, farm products, raw materials, financial services, computer software, and much more. In this book we mostly focus upon manufactured goods because they constitute the bulk of what is exchanged in international trade and can be most easily tracked using the available statistics. Also, the same trends that have been occurring with manufactured goods have been occurring with most other products as well.

Some economists suppose that the United States is in the process of transitioning from being a manufacturing-oriented economy to a services-oriented economy. They are not worried by the trade deficit in manufactured goods because they think that our trade surplus in services will eventually overcome it.<sup>12</sup> Indeed America has been exporting more services than it imports. But the surplus in services has not even come close to overcoming the trade deficit in goods. In fact, our trade surplus in services has been following a similar negative trajectory to the trade deficit in goods, peaking at 1.2% of GDP in 1996 and falling to 0.7% in 2006. Whenever we discuss the trade

deficit in this book, we are talking about the combined deficit in goods and services. That deficit has been going up.

Figure 1 shows the trend in the overall strength of the US dollar and for US exports and imports from the beginning of 1996 through the third quarter of 2007. From 1996 to 2002, the dollar rose relative to most of the world's currencies. Possibly as a result, US exports of goods and services fell. Since then the dollar has been falling against most currencies and US exports have been rising. When the dollar climbs (i.e., strengthens) as compared with other currencies, exports tend to decrease and imports tend to increase because US goods tend to get more expensive than foreign goods. When the dollar declines (i.e., weakens), imports tend to decrease and exports tend to decrease because US goods tend to get less expensive than foreign goods.

If US exports were the entire story, then the trade deficit would be on its way to solving itself. Even though US exports were rising, US imports were rising even faster, partly because US exports were



**Figure 1. Dollar Strength and US Exports**

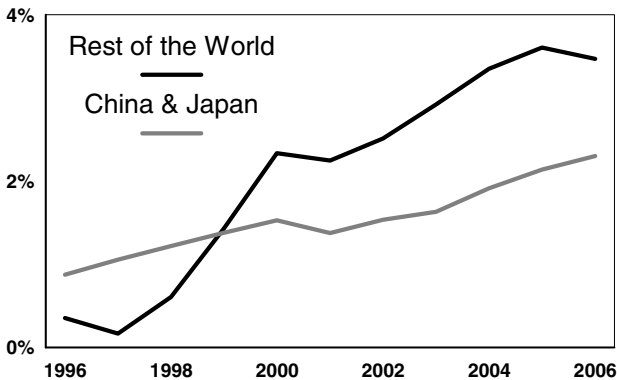
The dollar peaked in the first quarter of 2002. Exports bottomed out in the first quarter of 2002. Imports rose throughout the period, except for a brief drop during 2000 and 2001. (Source BEA and Federal Reserve Broad Index of the Dollar with January 1997 = 10.0.)

including an increasing percentage of imported components.

The trade deficit does not respond quickly to changes in the strength of the dollar. When the dollar was strong, foreign businesses increased their investment and American businesses reduced their investment. Then when the dollar fell, foreign businesses were still able to hold onto their market shares for quite some time, even at the new exchange rate. They did so by cutting their profit margins or by taking advantage of their increased productivity.<sup>13</sup>

As Figure 2 shows, the US trade deficit with China and Japan continued to grow, even though the depreciation of the dollar relative to the euro and many other currencies did cause the US trade deficit with the rest of the world to begin to fall in 2006. From the beginning of 2003 to the end of 2006, the dollar lost 21% of its value versus the euro (from .97 to .76 euros), but fell by only 1% versus the Japanese yen (120 to 119 yen) and by just 6% versus the Chinese renminbi (from 8.3 to 7.8 yuan). So long as some foreign governments, including the Chinese and Japanese governments, continue to manipulate their currency values in order to produce growing trade surpluses with the United States, the foreign-government-caused portion of the trade deficit will continue to climb steadily.

Trade deficits acquire a momentum of their own. When the exchange rate of the dollar goes up dramatically, it not only tends to



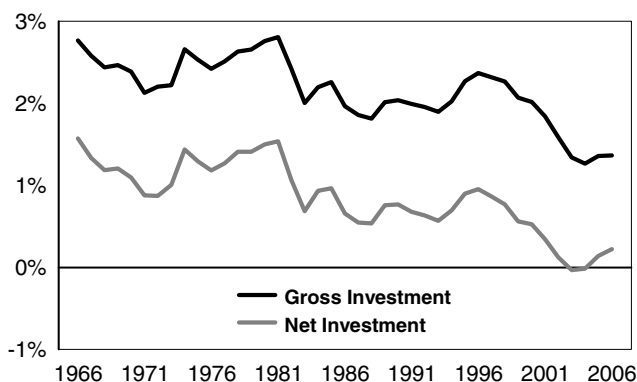
**Figure 2. US Trade Deficit as Percent of GDP**

The US trade deficit with China and Japan accounts for a steadily growing component of the overall trade deficit. (Source BEA)<sup>14</sup>

cause the trade deficit to go up, but it also tends to cause American manufacturing investment to go down. This lack of investment in manufacturing can, in turn, make future trade deficits worse.

When the broad index of the dollar rose dramatically during the period from 1996 through 2002, gross manufacturing investment declined steadily from 2.4% of GDP in 1996 to 1.3% of GDP in 2004 as shown in Figure 3, despite the fact that the cost of capital (as indicated by real long-term interest rates) was falling at the same time. In both 2003 and 2004 there was not even enough investment to replace wearing out plant and equipment as indicated by negative net investment those years. It wasn't until 2005 that manufacturing investment started a modest turn around, possibly in response to the weakening dollar that began in 2002.

Robert A. Blecker, a professor of economics at American University, performed the most extensive analysis of the effects of the exchange rate of the dollar (as measured by the broad index shown in Figure 1) upon American manufacturing investment. In a study published in the *International Review of Applied Economics*, he discovered that the exchange rate of the dollar was one of the four factors that caused manufacturing investment to change from year to year during the period from 1973 to 2004. Those factors were: (1) exchange rate of the dollar – higher exchange rate would cause less



**Figure 3. Manufacturing Investment as Percent of GDP**

Fixed investment in America's manufacturing sector declined as a percentage of GDP from 2.4% in 1996 to just 1.3% in 2004. (Source: BEA Fixed Asset tables)

investment, (2) the cost of capital goods – higher interest rate would cause less investment, (3) the GDP growth rate – faster growth would cause more investment, and (4) cash flow from undistributed profits and depreciation allowances – more cash on hand would lead to more investment.<sup>15</sup> During the period from 1995 to 2004, the rising exchange rate of the dollar proved to be such a powerful factor that it drove manufacturing investment downward, despite the fact that falling long-term interest rates were making capital goods less expensive.

In a July 2006 speech based upon this study, Blecker pointed to the accumulating evidence of the decline in manufacturing investment. He said:

According to my estimates, the rise in the value of the dollar since 1995 – which is a major cause of the trade deficit – has discouraged investment in US manufacturing to such an extent that the capital stock of the manufacturing sector was 17% lower in 2004 and new investment in US manufacturing was more than 60% lower in 2004 than they would have been if the dollar had not appreciated. Although the remaining manufacturing capacity is highly efficient, it accounts for a shrinking portion of US employment. Thus, the trade deficit does not simply cause a temporary reduction in output, but also a permanent loss of manufacturing capacity that can have long-lasting negative effects on the country's future productive capabilities.<sup>16</sup>

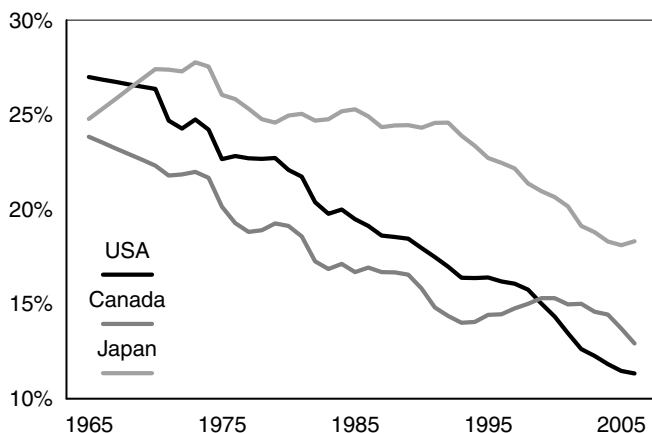
In 2006 Dan R. Mastromarco, a principal in the law and economics consulting firm Argus Group, pointed out that we are also losing our technological edge in manufacturing as evident from the decline in the number of engineering doctorates awarded to Americans by American graduate schools. He wrote:

When manufacturing moves overseas to China, India, East Asia, or Europe, it takes engineering know-how because engineers will ply their trade where the action is – outside the United States. While venerable U.S. engineering institutions still maintain their foothold, more than half of their doctoral degrees are awarded to foreign students.<sup>17</sup>

Imbalanced trade shifts manufacturing from the importing countries to the exporting countries. Figure 4 shows that in 1965, the United States had a larger percentage of its civilian workforce employed in manufacturing than Japan (27.0% compared to 24.8%).<sup>18</sup> Since then manufacturing employment has been declining throughout the world as a percentage of the workforce, due to the increased productivity of modern technology, but it has been falling more rapidly in the United States than in Japan and Canada, two countries that have similar wage rates and technology levels as the United States.

By 1970, Japan had passed the United States with 27.4% of its civilian population engaged in manufacturing, compared to 26.4% in the United States and Canada a distant third at just 22.3%. By 2006, the United States had fallen far below Japan and even below Canada, with just 11.3% of its civilian workforce engaged in manufacturing. (Japan had 18.3% and Canada had 12.9%.)

The loss of manufacturing jobs does not translate into unemployment in the US economy; it translates into lower median wages. The displaced workers eventually find jobs but at an average lower wage. When former Ford workers now flip burgers for much lower wages, good jobs were lost even though unemployment did not rise.



**Figure 4. Manufacturing Employment**

Manufacturing employment, as a percentage of the civilian labor force has been falling more rapidly in the United States than in Japan or Canada.

(Source: Bureau of Labor Statistics)

In 2005, three economists (Erica L. Groshen, Bart Hobijn, and Margaret M. McConnell) performed a study for the Federal Reserve Bank of New York where they estimated the number of jobs it would take to produce the net imports coming into the United States. They estimated the loss of jobs to have been at most 3.3 million jobs in 2003, which was about 20% of the total US manufacturing workforce at the time. Rather than point out that 1/5 of US manufacturing jobs had been lost, they minimized the extent of the problem as being just 2.4 percent of total US employment:

First, we determine that the offshoring of jobs has been a limited phenomenon: Our comprehensive estimate of the number of jobs embodied in US net imports is small relative to total employment in the United States – 2.4% of the total, at the most – both historically and in recent years. Moreover this estimate is sometimes positive and sometimes negative, suggesting that international trade does not necessarily mean a loss of jobs for the United States.<sup>19</sup>

It is true that manufacturing jobs can be gained from trade as well as lost. When trade is in surplus, jobs are gained, when trade is in deficit, jobs are lost. When the trade deficit diminishes, as it sometimes does, the number of jobs lost decreases. Unfortunately, in recent years, the job loss has been growing.

Given the increase in the trade deficit in goods and services from 4.6% of GDP in 2003 to 5.8% in 2006 and the increase in civilian employment from 138 million jobs in 2003 to 144 million in 2006, we extrapolate that if Groshen et al. conducted the same study today, they would find that by 2006, the trade deficit had caused a loss of up to 4.4 million jobs (27% of the 2006 manufacturing workforce).

Those who lost their factory jobs did not remain unemployed but competed for and found other work. Their competition had the effect of bringing downward pressure on wage rates in general. The resulting wage stagnation and worsening of the distribution of income has contributed to increased income inequality in the United States over the last three decades.

The decline in manufacturing and other exportable production

associated with the trade deficit is compounded by its long-term effects on American competitiveness. The loss of entire industries (e.g., television, computers and shoes) to competitors in other countries makes it difficult for the United States to reenter those markets later. A variety of economic models incorporate the benefits of building upon what already exists (factors such as increasing returns to scale and the roles of intellectual property and learning-by-doing). By continuing and allowing policies that sustain the trade deficit, we prevent American firms from gaining the scale and competitive advantage that they might otherwise achieve, and we destroy firms that previously had a competitive position (and would not have lost it were trade in balance).<sup>20</sup>

### **Other Explanations for Loss of Manufacturing**

The vast majority of economists believe in free trade so much that they have blinded themselves to the obvious cause of the loss of American manufacturing jobs: the government actions that drive the trade deficits. Instead, they have either minimized the problem or have offered alternative explanations.

Some have argued that the nearly full employment in the American economy is evidence that the effects have been minimal. But the damage done by the deficits is not that they caused unemployment but that they caused wages in the United States to stagnate and made the distribution of income more unequal. The workers displaced by imports found jobs at lower wages, which is what the “law” of supply and demand predicts.

Some have argued that American manufacturing jobs were displaced by technological changes. This argument is suspicious on its face. We have had technological changes throughout the past two centuries with no negative effects on the level of wages; indeed, wages rose continuously because of the increasing productivity that technological change produced. However, recent decades have been marked by widening disparities and a stagnation in median wages. The major problem is that most new products are not being produced in the United States. Instead, we import them and boost the trade deficit instead of manufacturing employment.

Some economists believe that America's current wage stagnation has been the result of the poor performance of our educational system. College graduates, especially those in scientific, technological, medical, and professional fields, have indeed realized substantially increased employment at high wages. It is argued that too few of our students go on to college, and therefore they qualify only for lower paid jobs. The argument is not convincing. You don't need a college degree to build airplanes with Boeing (highly labor-intensive); you don't need a college degree to build a Deere tractor or a Caterpillar bulldozer. Those are all big exporters and they all pay high wages. The trouble is that they and hundreds of other American firms are not exporting enough.

None of these explanations is as likely as the obvious conclusion that the trade deficits are responsible. By allowing the trade deficits, we have been deindustrializing our country.

### **Effect on Income Distribution**

The US economy was enjoying full employment in 2006, but the millions of workers displaced by the trade deficits reentered the job market and the increased number of workers looking for jobs resulted in lower wages for all workers with the exception of those insulated from foreign competition such as Wall Street brokers, professionals, professors, and federal government employees *inter alia*! This is one of the principal reasons for the wage stagnation and the worsening distribution of income observed during the past two decades. The average wage adjusted for inflation in all private industry rose 2.2% per year from 1948 to 1978 but only 1.3% per year from 1978 to 2005. Although exports create jobs, the effect of trade deficits is to cause the loss of more jobs from imports compared with the gains from exports.

Had exports increased during the past two decades in proportion to imports, the workers who lost jobs in low-wage industries like textiles and shoes would have found more productive and better-paying jobs in expanding export-oriented companies like Caterpillar, Deere, Boeing, Harley Davidson, Intel, Texas Instruments, GM, and Ford. Balanced trade would have raised the incomes of US workers

without harming our trading partners.

Federal Reserve Chairman Ben S. Bernanke disputes our interpretation. In a long 2007 speech devoted to the growing income inequality problem within the United States, he acknowledged that loss of jobs in import-competing industries was indeed occurring, but argued that such jobs would be replaced by jobs in exporting industries. Specifically:

International trade, another aspect of globalization, may also have differential effects on the economic well-being of U.S. workers, even as it tends to raise real wages and incomes on average. For example, some empirical research suggests that, in the 1980s and 1990s, increased international trade reduced the profitability and hence the demand for labor in a number of industries that employed relatively low skilled workers (Borjas, Freeman, and Katz, 1997; Sachs and Shatz, 1994). Of course trade has increased the *potential* [italics added] markets for other domestic industries, leading to higher demand and thus higher real wages for workers in those industries.<sup>21</sup>

Although this argument sounds plausible, it had a 760 billion dollar hole in it in 2006. The word “potential” is key to understanding his fallacy. If trade were in balance, then what Bernanke said would be perfectly true. Unfortunately for American workers, the jobs in exporting industries are only “potential” jobs, not actual jobs, *because of the trade deficits!*

#### **DANGER OF HARD LANDING**

As a result of the trade deficits, the United States has been buying consumer goods on credit, going further and further into debt since the middle of 1985. This position of the United States is particularly dangerous because much of our debt is to a rising power and potential enemy in the international system – China. This is an almost unprecedented development, but the best parallels do not bode well for continued American power.<sup>22</sup>

There are two possible ways that the United States could come out of debt. In the “soft landing” scenario, we could work our way out of debt by producing goods and services for export. In this scenario,

American investment in trade-oriented goods and services increases in order to increase exports and to replace goods and services that Americans are buying from abroad. The trade deficit gradually improves.

Unfortunately, with more and more countries joining the Chinese and Japanese in buying dollars in order to build up their exports at our expense, and with China moving into more and more of our remaining industries, including automobiles, unless we take steps to fight dollar mercantilism, it is unlikely that a soft landing will take place while the United States still has industries left that can compete in world markets.

The alternative to the “soft landing” is the “hard landing.” Once the run on the dollar begins, the dollar would fall to a fraction of its former value — the longer the hard landing is delayed, the less of our industry would be left at the time it takes place. The less industry left, the harder the landing, and the slower the recovery. After the hard landing, things would suddenly be different in the United States.

Other countries have gone through currency crashes, so what would happen is really not a mystery. Prices in the stores, especially prices of foreign-made goods, would go sky-high. In just one month, the cost of imported goods could double, triple, or quadruple. Interest rates would skyrocket. Some retail stores would fail because of the sudden decline in demand for their merchandise. The housing market would go bust, partly because of the skyrocketing mortgage rates and some home owners would sell their homes for a fraction of what they had once been worth. People who had taken out variable rate loans would face much higher interest costs and many would go broke, no longer able to pay the interest on their debts. The sudden growth in business and personal bankruptcies could cause many banks to fail. Energy prices, especially gasoline prices, would skyrocket.

The news would not be altogether bad. There would be a great boom in the secondhand industry. Secondhand stores would move into some of the buildings vacated by closing banks and retail stores. Our remaining manufacturing industry would be working around the clock, absorbing some of those who had just lost their jobs in the

financial, real estate, and service sectors.

The United States would have a very tough year, but the following year would see the beginning of a recovery which would continue, unless we were to enact stupid economic policies that would prevent it. Those foolish policy options might be quite enticing. Whichever political party would be presiding at the time of the crash would likely be out of power for a couple of decades and the other party would fall back on its radical fringe.

If the Republicans were in power during the crash, then the left-wing big-government enthusiasts at the fringe of the Democratic party would likely turn America into a socialist state that would sap American incentive.

If the Democrats were in power, then the right-wing isolationists at the fringe of the Republican party would likely turn American into a country isolated as much as possible from the world economy. They would encourage import-competing industries (using tariffs) and discourage exporting industries (possibly with export restrictions).

The Argentine experience could be an example of what to expect. In 2002, the Argentine peso collapsed on world currency markets to about a quarter of its former value, giving Argentina a 10% inflation rate in a single month (March, 2002) and a decline of GDP of about 11% in a single year. Then, from 2003 through 2005, the Argentine economy recovered rapidly, growing by about 9% per year.

The Argentine government's mistakes during their recovery were rampant. In order to raise government revenue, the Argentine government imposed tariffs on imports, which encouraged the growth of inefficient import-competing industries. At the same time, they discouraged exports, especially beef exports. In March of 2006, President Kirchner actually banned beef exports (in order to reduce the prices paid by Argentine consumers). He later rescinded the outright ban, but still kept export controls that reduced beef exports to 70% of their 2005 level. As a result of similar mistakes under Peron after World War II, Argentina was one of the slowest-growing economies of the postwar twentieth century.

Some economists have argued that since the United States debt,

unlike third-world debt, is denominated in our own currency, the dollar would not crash very far, nor would the effects be severe. They may be ignoring the fact that interest rates in the United States would likely skyrocket as a result of the sudden decrease in foreign savings coming into the country. They also may be ignoring the fact that a dollar crash would send stock markets plummeting throughout the world, thrusting the entire world into recession or depression.

It is true that we would not have the post-crash third-world problem of paying an increased amount of principal to repay our debt. We would have a different problem that could be equally severe, a skyrocketing interest rate on our debt. Since January 2006, the Federal Reserve has been holding US short-term rates above long-term interest rates causing foreign investors to gradually move their financial holdings into short-term holdings. The payments on short-term holdings go up as US interest rates rise, as would the debt payments by those Americans who have borrowed using credit cards or adjustable-rate loans. The rise in interest payments would drive many Americans into bankruptcy and they would take some financial institutions down with them. The Federal Reserve might try to alleviate these problems by intentionally inflating the dollar, but monetary inflation would cause its own set of problems.

The main problem is that our exports would not increase fast enough to slow the fall in the dollar. Although American automobile companies and some others would increase their production, we would still be importing oil and consumer goods at much higher prices. There would not be a sufficient increase in exports to stabilize the dollar until new investments in American production would come on line.

Paul Krugman argues that the extensive US investments abroad would result in an increased flow of income from abroad which would stabilize the dollar.<sup>23</sup> He might be right, but on the other hand, the crash of the dollar would cause a stock market crash around the world. While there would be an increased flow of income from abroad, it might not be enough to stabilize the dollar.

When the Argentine peso collapsed, few other countries were affected, but the effect of a dollar collapse would be worldwide.

Although we could export our way to continued prosperity in the “soft landing” scenario, a hard landing would mean a worldwide recession or depression. Increased demand for Asian exports in the United States helped the Asian Tigers recover from their currency crashes in the 1990s, but there would probably not be much increase in demand for American products from a depressed world economy.

Crashes tend to overcompensate. They often go beyond the minimum amount necessary in order to correct an imbalance. The wishful thinking by economists that the dollar crash would be mild may just be another example of the wishful thinking that got the United States into this mess in the first place.

In this chapter, we have shown that the trade deficit has been disastrous for the American manufacturing sector. We have assumed, given the growing trade deficits, that other American products involved in international trade have been similarly affected. Dollar mercantilism has taken a major toll on the US economy.

Investment in the manufacturing sector has been declining, which has destroyed good-paying jobs and led to an increasing inequality of income. Unless we deal with the trade deficit, we will face a steady decline in our tradable sectors. At the same time, we will face a growing likelihood of a sudden hard landing characterized by high interest rates, high inflation, and a high level of bankruptcies. The consequences of the hard landing could be the end of the United States as the world’s predominant power. China, already the rising international power, is granted an additional weapon by our debt and deficits – the capacity to undermine the US financial system and produce a hard landing any time it decides to dump dollars on world currency markets.

