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Global Future Council on International Trade and Investment

Strategic Brief on Misconceptions around Trade Balances

The Global Future Council on International Trade and Investment has made the case for global trade cooperation. It has called for continued efforts from all stakeholders to invest in and identify improvements to the rules-based international trade and investment architecture. It has underscored the importance of advancing an inclusive growth agenda. For inclusive growth to be achieved, it is crucial that misconceptions about the trade balance be avoided. The following briefing addresses seven of these.

A widely held view is that a country's trade balance is a key measure of its international commercial success. It is common for an increase in a trade surplus to be described as "an improvement" and a decline in a trade balance as "a worsening". In this paradigm, exports are good and imports are bad, and the aim of trade policy is to generate trade surpluses that are as large as possible both in the aggregate and bilaterally with each trading partner. It is argued that trade surpluses are desirable because they increase national welfare, employment and economic growth, while deficits do the opposite. Based on this conceptualization, narratives have emerged in some countries and regions that "unfair" trade policies have led to large trade deficits, particularly in goods trade, which in turn have driven a decline in manufacturing employment over the past two decades. This is the case in the United States as well as elsewhere. Currently, invoking this reasoning, the administration is seeking to reduce the trade deficit by renegotiating US trade agreements and adopting more protectionist US policies.

The emphasis on trade balances is, however, a poor guide to understanding past sources and implications of trade performance. Moreover, if used as a guide for policy, it could have seriously deleterious and counterproductive effects. Trade deficits are not necessarily bad, do not necessarily cost jobs, and are not a measure of whether trade policies or agreements are fair or unfair. Efforts to use trade policy and agreements to reduce either bilateral or overall trade deficits are unlikely to yield domestic growth and jobs. Quite the opposite and the result could actually harm the very people such an approach aims to help.

Misconception 1: "Trade deficits are bad, trade surpluses are good"

The basic purpose of trade is not to run trade surpluses, but rather to allow countries to import goods and services by giving up fewer resources than would be required if they tried to produce such goods and services at home. It is more accurate to think of imports as the benefits of trade, and exports as the costs that need to be paid to obtain these benefits. This means it is more appropriate to view national welfare as enhanced by improving the terms of trade – in other words, giving up as few exports as possible to obtain a given quantity of imports, rather than by maximizing exports and minimizing imports.

The trade balance – defined here as the current account which includes the balance on trade in goods, services and net factor incomes – reflects not only what is happening in the market for goods and services but, simultaneously, net international flows of capital. Countries with trade deficits are earning less from their exports than they are paying for

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their imports and borrow from the rest of the world to make up the shortfall. Conversely, countries with trade surpluses are earning more from their exports than they pay for their imports and are accumulating claims on foreigners by lending to them. There is no straightforward relationship between the state of a nation's trade balance and the state of its economy. A deficit could indeed be undesirable if it indicates borrowing and spending levels that are unsustainable. But it could also enhance welfare if it is used to smooth consumption in the face of temporary emergencies or to finance investment in excess of domestic saving. Similarly, a surplus could be desirable if it generates higher returns than domestic investments, but it could be undesirable if it comes at the expense of needed domestic expenditures. So whether international borrowing is good or bad depends on what the nation is doing with the money.

Misconception 2: "Bilateral trade between countries should be balanced"

One of the benefits provided by trade is the ability to buy from some partners and sell to others. The preference for balancing bilateral deficits is as misplaced as would be a preference that an economy be based on barter rather than on money. A monetary economy is superior to a barter economy because it does not require "a double coincidence of wants". It allows individuals to specialize and earn money by running surpluses with their employers and then spending money on goods and services that meet their needs by running deficits with everyone else. By analogy, in not balancing trade bilaterally, country A reaps gains from trade by exporting to those nations that need the products in which it specializes, and then importing from other nations that produce the products best suited to its needs. If a bilateral free trade agreement allows a country to meet more of its needs by importing at lower costs from a particular partner, it will benefit, even if the value of these increased imports exceeds the value of the exports that it sells to that partner.

Misconception 3: "Trade deficits mean job loss"

Trade deficits are often said to cause reductions in employment and growth, while surpluses are said to increase them. Indeed, it is sometimes common practice to add the domestic employment content of exports, and subtract the domestic employment equivalence of imports, to derive an estimate of the jobs gained and lost "due to trade" both in the aggregate and with individual trading partners. But such calculations, apart from being difficult to measure, can be quite erroneous. Trade balances are outcomes – or what economists call endogenous variables –not causes. Trade balances also occur for a variety of reasons, and without identifying these basic reasons, it is difficult to draw inferences about what trade balances mean for either employment or growth.

Without knowing why imports are growing, it is impossible to know the impact on domestic production and employment. Imports, for example, could increase (and the trade balance could decline) either because: (a) there is an increase in domestic income thereby increasing demand all round; or (b) the price of foreign products falls relative to domestic products. But the employment effects of these reasons

Figure 1: Relationship between US employment and imports, 1990-2016

Source: Federal Reserve Bank of St. Louis FRED database

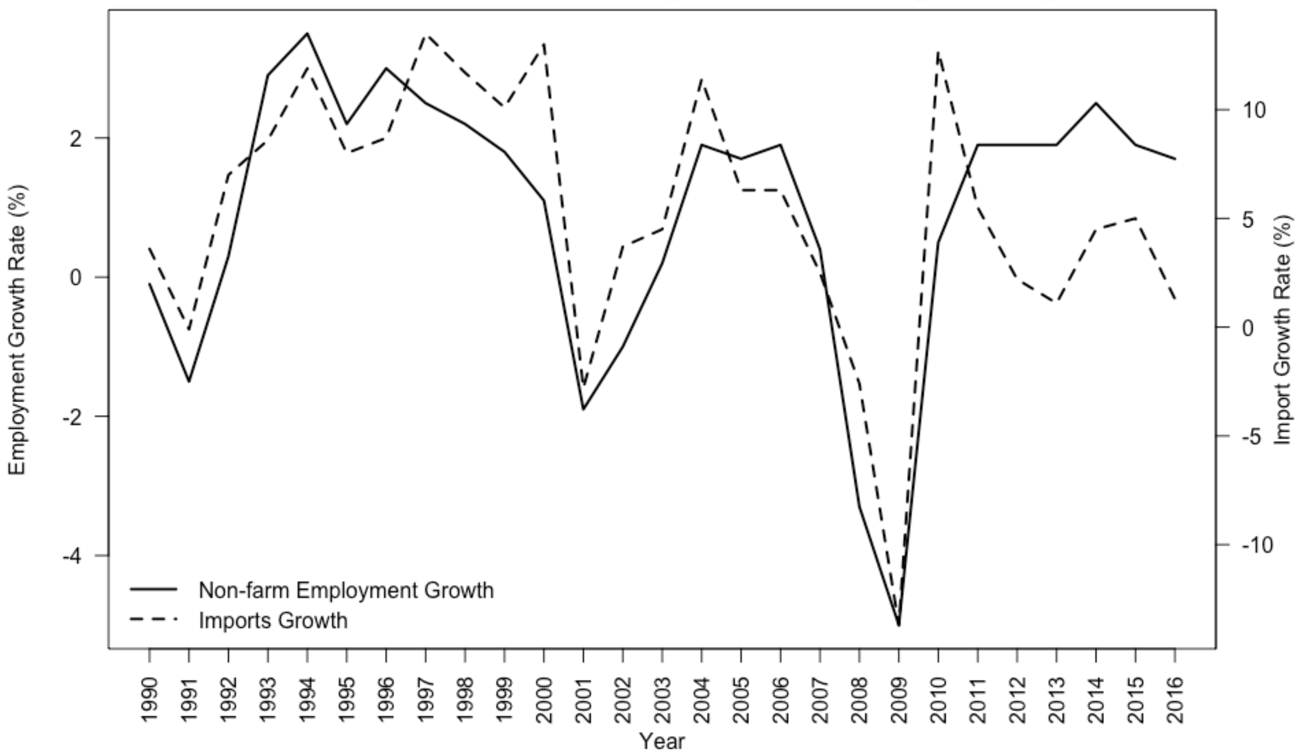

Figure 2: Relationship between US GDP growth and trade balance, 1999-2017

Source: OECD statistics

for increased imports will be very different. If the cause is higher domestic income, there will be more spending on both domestic and foreign products, and thus increased imports and a larger trade deficit will be positively associated with employment and growth. However, if the cause is a decline in the price of imported products relative to domestic products, owing, for example, to an improvement in foreign productivity growth, increased imports could lead to fewer sales of domestic products, slower growth and a decline in the employment of domestic workers.

As Figure 1 suggests, changes in income in the United States have dominated import growth, and so the association between imports and domestic employment has been overwhelmingly positive. Similarly, Figure 2 shows that smaller trade balances have been associated with faster US economic growth. While in theory the relationship between imports, trade deficits, and employment and growth could be positive or negative, in practice in the United States, rapid import growth and larger trade deficits have been associated with faster employment growth. Careful estimates of the impact of trade on employment should separate changes in import growth attributable to improved foreign competitiveness from changes due to increased domestic demand.

Misconception 4: "Imports are the cause of the decline in manufacturing jobs"

Making this separation is crucial in understanding the role played by international trade in the decline in manufacturing employment in advanced industrial countries. A careful study by Acemoglu, Autor, Dorn, Hanson and Price (2016), which separates determinants of import growth, estimated the effects of increases in Chinese competitiveness on US manufacturing employment. The authors find that from 1999 to 2011, when US manufacturing employment declined by 5.5 million, the loss of manufacturing jobs attributable to China amounted to just under 1 million. Moreover, it is noteworthy that between 1973 and 2010, the decline in the share of manufacturing employment in a country such as Germany that has had large surpluses in manufacturing trade has been quite similar to the declines in the share of manufacturing employment in the US with its manufacturing trade deficit.

Misconception 5: "Reducing manufactured goods imports will increase manufacturing employment"

It is well known that a tax on imported inputs can reduce exports. For example, placing tariffs on imported fabric will make clothing exports more expensive. As the work by the OECD and the World Trade Organization (WTO) have underscored, products are "made in the world" using global value chains rather than entirely manufactured in just one country. New barriers to trade could disrupt production and reduce rather than increase domestic employment in both the protected industries and those that use their outputs.

Misconception 6: "Trade agreements will increase the deficit"

In a closed economy, national saving must equal national investment. Capital can be accumulated in the form of increased investment in plant, equipment and inventories, either by investors abstaining from consumption and spending their money on investment, or by borrowing the saving of others. In an open economy, however, it is also possible to borrow from foreigners. This allows additional domestic investment beyond the level generated by domestic saving. A current account deficit will not only indicate net foreign borrowing, but also the difference between national saving and national investment. It is indeed an identity wherein the trade balance (exports minus imports) will equal saving minus investment.

The trade balance is a function of national saving and investment, not of trade policies. Unless they change national saving or investment, trade policies will have no impact on the trade balance; many trade policies are likely to leave aggregate saving and investment unchanged. Consider for example, the imposition of a quota on imports of sugar. If binding, this will certainly reduce the quantity of sugar that is imported, but if residents do not alter their saving or investment behaviour –and it is not obvious why a sugar quota would induce such a change – the current account would not be affected. Rather than a smaller overall trade deficit, with no change in saving and investment, the quota would result in larger deficits in other components of the trade balance. One mechanism by which this would operate is through the exchange rate. If a country imports less sugar, its demand for foreign currency is likely to be reduced. This, in turn, is likely to strengthen its exchange rate, thereby making its exports more expensive in foreign markets and other imports relatively cheap at home. Therefore, in addition to reducing sugar imports, the quota could also reduce exports and increase imports of other products.

To be sure, in principle, indirect channels exist through which trade policy may affect national saving or investment. It is possible, for example, if an economy has high levels of unemployment, that trade policies that increase exports or reduce imports could increase domestic income and saving. It is similarly possible that there could be increases in the trade balance due to trade policy, if the revenues from higher tariffs are saved or if trade policies increase the profits and savings of domestic firms. But these links are tenuous, and it is more likely that aggregate saving and investment over the long run will be driven by other, more powerful factors.

Both saving and investment depend heavily on decisions about the future, whereas exports and imports are usually related to income and relative prices at a particular point in time. (See Obstfeld and Rogoff (1995) for a comprehensive survey of the current account from an intertemporal view.) Saving involves abstaining from consuming current income and reflects a preference to consume tomorrow rather than today. Macroeconomic theory explains private decisions to save on the basis of variables such as current income, wealth, demographics, and expected future income and interest, and government saving will reflect decisions to tax and spend. Similarly, investment reflects expectations about the ability to obtain future profits that are greater than the costs of borrowing.

In sum, while trade policies such as quotas would be expected to change the composition of exports and imports, unless saving and investment are altered, the outcomes are likely to be offset by changes in relative prices and exchange rates. Those who claim unfair trade policies or bad trade agreements have a permanent impact need to explain how these policies have reduced long-run saving and/or increased investment. And while it is not impossible to produce theories that could link trade policies and saving and investment, especially over long periods of time, spending decisions are unlikely to be affected by whether or not trade is fair.

It is not hard to find examples of countries with high trade barriers that have run large trade deficits or countries with low barriers that have trade surpluses. Indeed, the International Monetary Fund is famous for arguing that countries with current account problems are too protectionist and for advocating trade liberalization as part of its structural reform programme. India was one of the most highly protected economies in the early 1990s when it experienced unsustainably large trade deficits, and Chinese trade liberalization after joining the WTO was associated with large trade surpluses. Consider that Singapore, a country with more limited trade barriers, has run a current account surplus equal to around 20% of GDP in recent years.

Misconception 7: “Reducing bilateral trade deficits will lead to smaller deficits overall”

Trying to reduce the aggregate trade deficit by reducing bilateral trade deficits without changing saving and investment is like squeezing the air in one part of a balloon. While the squeezing could create a dent in one place, it would simply redistribute the air to other parts of the balloon.

Ultimately, trade policies are at best a set of blunt instruments that do not directly affect the determinants of a trade balance. Nor should there be a fixation on the trade balance as an economic indicator. The state of a nation’s trade balance says very little about the health of its economy, while aiming for balanced trade with individual trading partners will only generate distortions and constrain the diversity of goods for purchase while raising prices, with no benefit to national welfare.

Focus instead on driving inclusive economies

Although deindustrialization is a major concern, its causes do not stem primarily from trade, and policies aimed at reviving manufacturing by targeting trade will miss the mark. Indeed, as global inputs are needed to manufacture products, policies aimed at reducing imports can end up hurting rather than aiding employment. Such policies could also hurt downstream jobs related to services.

The alleged chain of causation that runs from unfair trade and bad trade agreements, to large trade deficits, employment declines, and reductions in welfare and growth is not accurate. It also overlooks the contribution of services to economic growth. Better to focus instead on building open economies with complementary policies and institutions that allow the potential created by global markets to be converted into broad opportunities for people and business. In the face of rapid technological change, robust policy frameworks covering a spectrum of socio-economic domains and structural factors are needed to ensure all can cope.

This Global Future Council has outlined why trade and investment still matter to drive growth. It has recognized that the benefits of cross-border commerce have not yet reached all, that some have been left behind by the associated disruption, but that a focus on trade policy alone cannot fix all the economic challenges policy-makers face. It has also outlined steps towards an inclusive growth and trade agenda as a path to deliver the widespread jobs and opportunities the world so badly needs.

Endnotes

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