12 Myths of International Trade

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Joint Economic Committee Staff Report
Office of the Chairman, U.S. Senator Connie Mack

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FOREWORD

International trade is characterized by numerous myths, many of which are potentially harmful to our economic health. Thus, it behooves us to increase our understanding of this topic. This booklet analyzes 12 of the most common myths. It also provides an understandable explanation of how international trade impacts the lives of Americans.

As technology reduces the costs of transporting both information and goods, markets become more competitive and trade across national boundaries more commonplace. Some fear these developments. However, we must not delude ourselves. Make no mistake about it—Americans derive enormous benefits from international exchange. Without trade, our modern living standards would be impossible.

Since this booklet was first released in June 1999, we have received numerous requests for copies. Many readers told us that it clarified several issues that had previously been puzzling to them. With that in mind, we are releasing this new edition that incorporates recent revisions in the GDP figures and a short section on the empirical relationship between open international markets and economic performance. I hope you will find it both understandable and highly informative.

Senator Connie Mack, Chairman,
Joint Economic Committee

The evidence is overwhelmingly persuasive that the massive increase in world competition ¾ a consequence of broadening trade flows ¾ has fostered markedly higher standards of living for almost all countries who have participated in cross-border trade. I include most especially the United States.

ALAN GREENSPAN
Speech before the Alliance for the Commonwealth, Conference on International Business, Boston Mass. on June 2, 1999

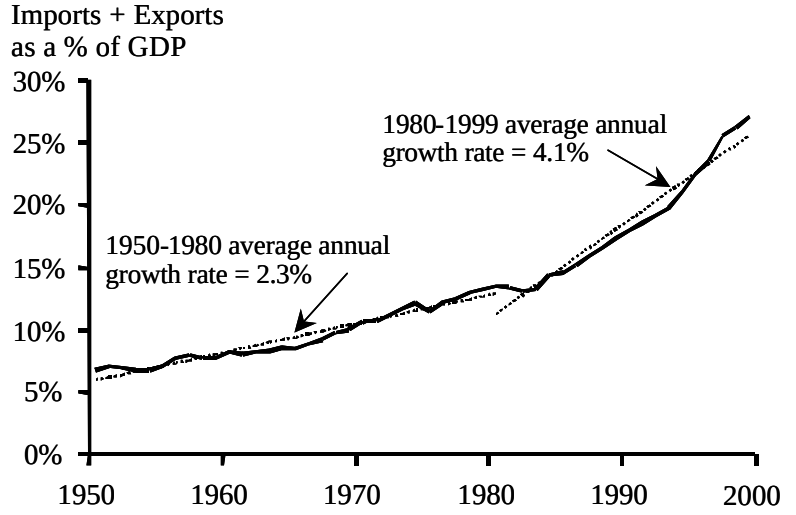
I. GROWTH OF THE TRADE SECTOR

Spurred along by both reductions in trade barriers and falling costs of transportation and communications, the volume of international trade has been growing rapidly throughout the world. Approximately 21 percent of the world's total output is now sold in a different country than it was produced; double that of 1960.

As Figure 1 shows, the trade sector has also grown rapidly in the United States, particularly since 1980. Between 1950 and 1980, international trade (imports + exports) rose from 6.7 percent of GDP to 13.5 percent. Since 1980, trade as a share of the economy has doubled again, soaring to 27.2 percent of GDP in 1999.

Figure 1: Trade as a Share of Real GDP, 1950-1999

The trade sector (imports plus exports as a share of GDP) has grown rapidly, particularly during the last two decades. In 1999 it reached 27.2% of GDP, up from 13.5% in 1980 and 6.7% in 1950.



Source: Haver Analytics

II. WHY IS INTERNATIONAL TRADE IMPORTANT?

Because of trade, individuals, companies, regions and nations are able to specialize in the production of things they do well and use the earnings from these activities to buy from others those items for which they would be high-cost producers. As a result, trading partners are able to produce a larger joint output and achieve a higher standard of living than would otherwise be possible. Economists refer to this as the law of comparative advantage.

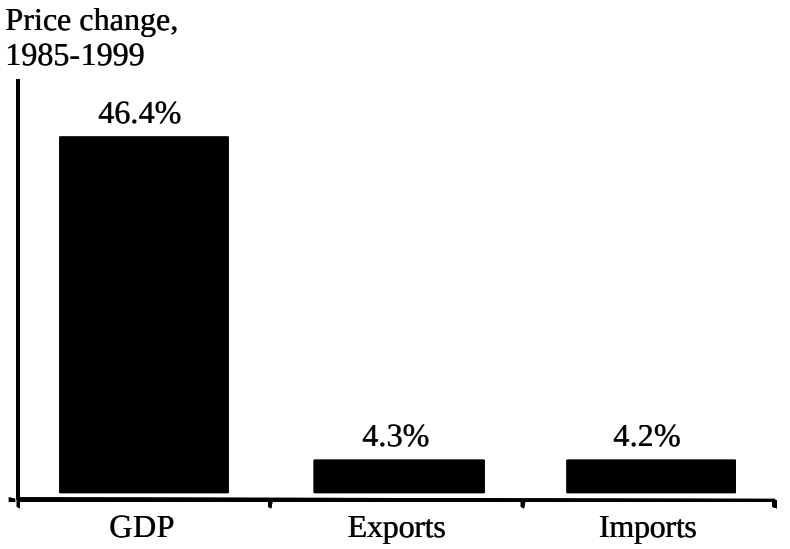
The law of comparative advantage holds that individuals can gain by specializing in those activities where they have a relative advantage. For example, even though most doctors might be good at record keeping and arranging appointments, it is nonetheless generally in their interest to hire someone to perform these services. Time they spend keeping records is time they could have spent seeing patients. Given the value of their time with patients, their earnings will be reduced as more of their time is spent keeping records, and less seeing patients. The relevant issue is not whether doctors are better record keepers than the assistants they could hire, but rather how doctors use their time most efficiently.

The principle involved here applies equally to nations. The citizens of each nation can gain by spending more of their time and resources doing those things where they have a relative advantage. If a good or service can be obtained more economically through trade, it makes sense to trade for it rather than to produce it domestically. It is a mistake to focus on whether a good is going to be produced domestically or abroad. This is of little importance. The central issue is how the available resources can be used to obtain each good at the lowest possible cost. When trading partners use more of their time and resources producing things they do best, they are able to produce a larger joint output, which provides the source for mutual gain.

International trade also leads to gains from the competitive process. Competition is the mother of both innovation and efficient production. International competition helps keep domestic producers on their toes and provides them with a strong incentive to improve the quality of their products. The experience of the U.S. auto industry illustrates this point. Faced with stiff competition from

Figure 2: Price Changes — Imports and Exports Compared to GDP Deflator, 1985–1999(Q4)

The prices of goods and services involved in international trade have increased less than the general price level. Intense competition helps keep prices low in these markets.



Sources: Haver Analytics; *Economic Report of the President,* 2000, b-7.

Japanese firms during the 1980s, U.S. automakers worked hard to improve the quality of their vehicles. As a result, the reliability of the automobiles and light trucks available to American consumers, including those produced by domestic manufacturers, is almost certainly higher than would have been the case in the absence of competition from abroad.

Figure 2 illustrates the impact of dynamic competition in international markets. While the overall price level rose 46.4 percent between 1985 and 1999 (Quarter 1), the price increases of exports (4.3 percent) and imports (4.2 percent) during this lengthy period were much smaller. The low prices reflect the importance of innovation and high productivity in these markets.

III. PRIMARY SOURCE OF TRADE FALLACIES

Despite the gains derived from trade, fallacies abound. Why is there so much misunderstanding surrounding trade issues? The primary source of confusion is a failure to consider the secondary effects ¾ indirect effects that are triggered by an initial change. As the accompanying Thumbnail Sketch indicates, key elements of international trade are closely linked. As a result, you cannot change one element without changing the others. This is the case with imports and exports. Imports cannot be limited without also limiting exports. Our imports provide foreigners with the dollars required to purchase our exports. Trade restrictions that reduce our imports will also reduce the dollar earnings of foreigners. As their dollar earnings fall, foreigners will have to cut back on their purchases from us. Trying to limit imports without simultaneously reducing exports is like trying to hit a baseball up without having it come down.

The foreign exchange market will bring the quantity of dollars demanded by foreigners to purchase things from Americans into equality with the quantity supplied by Americans to purchase things from foreigners. This means that overall, our payments to, and receipts from, foreigners must balance. Thus, a deficit in one area, goods and services for example, is not an isolated event. A goods and services trade deficit implies an offsetting surplus in other areas. More broadly, if a nation is running a current account deficit, it must also be running a capital account surplus. The reverse is also true; a capital account surplus implies a current account deficit.

This pamphlet will address 12 of the most common myths of international trade. As we will see, time and again, trade fallacies arise because of the failure to consider the secondary effects implied by fundamental linkages. Let us turn to some of the more enduring myths of international trade.

Some Key Relationships of International Trade
¾ *A Thumbnail Sketch*

1. Exports and imports are linked. U.S. exports provide Americans with the foreign exchange required to purchase imports. Similarly, U.S. imports provide foreigners with the dollars required to buy things from Americans.

2. The exchange rate will bring the quantity of dollars foreigners demand in order to make purchases from Americans into equality with the quantity Americans supply in order to make purchases from foreigners.

3. Exports + Net Foreign Investment = Imports[1]

4. When the exchange rate is determined by market forces, the current and capital accounts must balance. Therefore, when there is a capital account surplus ¾ that is a net inflow of capital ¾ there must also be a current account deficit of equal size.[2]

[1] This formula omits net investment income and unilateral transfers, both of which are small relative to the trade and capital flows of the United States.
[2] The Current account includes investment income and unilateral transfers, as well as the trade balance on goods and services. When we speak of the trade surplus or deficit, we are referring to the balance on goods and services rather than the narrower balance on merchandise trade.

TABLE 1: TWELVE COMMON MYTHS OF INTERNATIONAL TRADE

1. Trade is a zero-sum activity. If one trading party gains, the other must lose.

2. Imports reduce employment and act as a drag on the economy. Exports promote growth and employment.

3. Tariffs, quotas and other import restrictions will save jobs and promote a higher level of employment.

4. When a high-wage country trades with a low-wage country, the wages of workers in the high-wage country will be pulled down.

5. It is sound policy for a country to support a weak industry with subsidies. A liberal interpretation of "dumping" is necessary to protect domestic industry.

6. A trade surplus is good; a deficit is bad.

7. A trade deficit is the result of bad economic policy. It indicates that the economy is in trouble.

8. If trade with another country is fair, our exports to the country will equal our imports from it.

9. A country cannot continue to run trade deficits year after year.

10. A country that runs a trade deficit loses jobs.
    A country that runs a trade surplus gains them.

11. Our merchandise trade deficits indicate that the U.S. is de-industrializing.

12. Pegged exchange rates are a good strategy. They allow a country to have relatively stable exchange rates while still pursuing an independent monetary policy.

IV. TWELVE MYTHS OF INTERNATIONAL TRADE

Myth 1 *"Trade is a zero-sum activity. If one trading party gains, the other must lose."*

Mutual gain provides the basis for trade. International trade is no exception. Domestic producers are often able to sell products at attractive prices to purchasers abroad. On the other hand, domestic consumers will find it attractive to purchase various products from foreign suppliers. In essence, trade makes it possible for the people of a nation to sell at higher prices goods they produce cheaply and to buy at lower prices items that would be costly to produce domestically. What a deal! Gain is derived from both the higher prices for exported goods and the lower prices for those imported.

Modern production of goods, ranging from pencils to computers, involves the cooperation of literally tens of thousands of people. International trade facilitates this cooperative effort. Trade makes it possible for people in different nations with vastly different skills and resources at their disposal to specialize in those areas where they are low-cost producers, while trading for those items that would be costly for them to produce. This specialization makes it possible to produce a larger joint output than would otherwise be possible. In turn, the larger output allows each to achieve a higher standard of living.

Consider the case of trade between the United States and Brazil. The U.S. and Brazil are able to produce a larger joint output when Americans supply wheat and Brazilians coffee. The larger production will make it possible for Americans to gain by using revenues from their wheat sales to buy Brazilian coffee. At the same time, Brazilians will gain by doing the opposite, by using revenues from their coffee sales to buy American wheat. In turn, the larger joint output provides the basis for the mutual gains achieved by both.

Myth 2 *"Imports reduce employment and act as a drag on the economy. Exports promote growth and employment."*

This fallacy stems from a failure to consider the link between imports and exports. Our imports provide foreigners with the purchasing power to buy our exports. If foreigners are unable to sell as much to Americans, then they will have fewer dollars with which to buy from Americans. Therefore, when the volume of imports declines there will be an automatic secondary effect; foreigners will have fewer dollars with which to buy American goods.

Reflection on the function of the foreign exchange market can help clarify the relationship between imports and exports. The foreign exchange market will bring the demand for dollars in exchange for other currencies into equality with the supply. Foreigners demand dollars in order to buy goods and services from Americans (our exports) and to make investments in the United States. Americans supply dollars to the foreign exchange market in order to import goods and services and to make investments abroad. Therefore, the following relationship must hold:

Exports + Foreign Investment in U.S. = Imports + U.S. Investment Abroad

Foreign investment in the U.S. minus U.S. investment abroad is equal to net foreign investment. Thus, the above equation can be rewritten as:

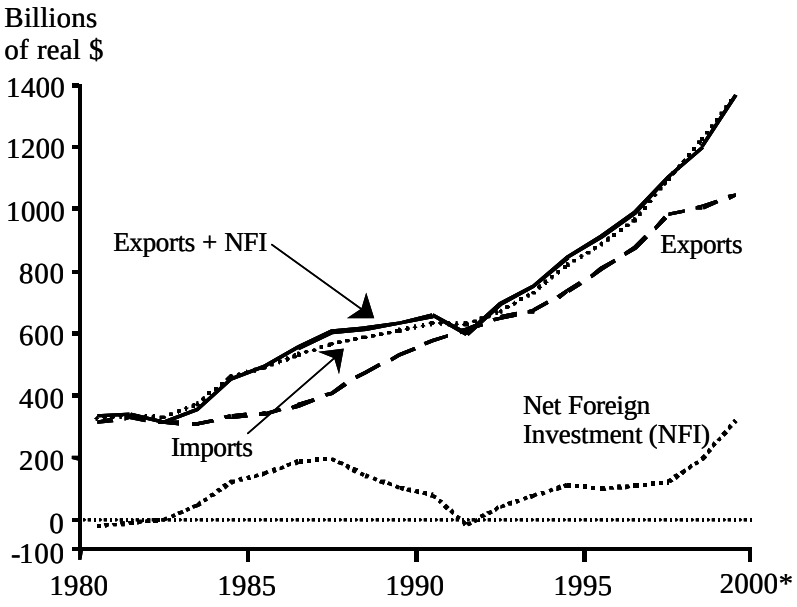
Exports + Net Foreign Investment = Imports

This equation illustrates an extremely important point: a change in imports will lead to a change of similar magnitude in exports plus net foreign investment. This is not some abstract concept dreamed up by economists. As Figure 3 shows, this relation holds in the real world.

As imports have grown rapidly during the last two decades, exports plus net foreign investment have grown by a similar amount.

Figure 3: Imports = Exports + Net Foreign Investment

As imports increase, exports plus net foreign investment increase by a similar amount. Any employment reductions due to imports growth are offset by employment increases in export industries and other activities resulting from lower interest rates accompanying the capital inflow.



Sources: Haver Analytics; *Economic Report of the President,* 2000, b-22.
Note: 1999:Q3 net foreign investment figure used for 2000—latest available.

Once this relationship is recognized, the fallacy of the "imports reduce employment" view is obvious. An expansion in exports will increase employment in our export industries, while an increase in net foreign investment will lower interest rates and thereby stimulate investment and employment throughout the economy. The expansion in employment, as the result of these two factors, will offset the employment reduction in import-competitive industries. There is no reason to expect any net change in overall employment.

Myth 3 *"Tariffs, quotas and other import restrictions will save jobs and promote a higher level of employment."*

Like the previous fallacy, this one also stems from the failure to recognize that a reduction in imports does not take place in isolation. When we restrict foreigners from selling to us, we are also restricting their ability to obtain the dollars needed to buy from us. Therefore, trade restrictions that reduce the volume of imports will also reduce exports plus net foreign investment by an equal amount. Thus, any jobs "saved" by the restrictions will be offset by jobs "lost" due to a reduction in exports and higher interest rates as a result of the decline in the net capital inflow.

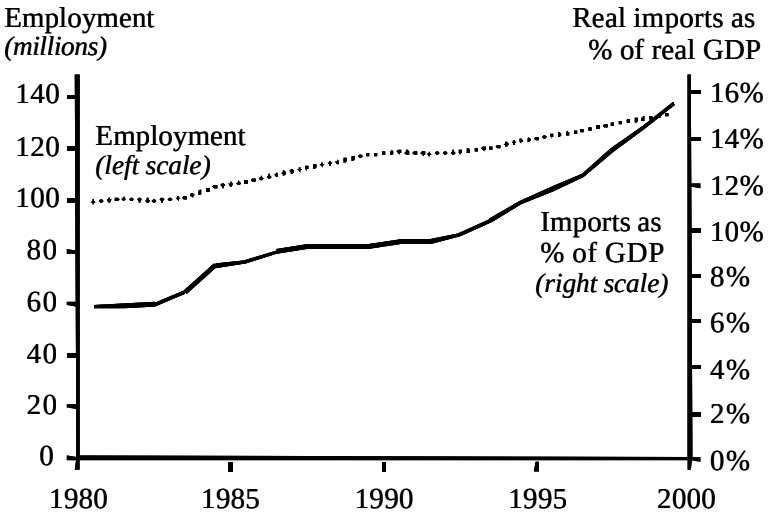
As Figure 4 shows, the U.S. has experienced an unprecedented expansion in imports as a share of the economy. But this did not retard employment. Civilian employment in the U.S. rose from 99 million in 1980 to 119 million in 1990 and 133.5 million in 1999. Thus, the unprecedented growth of imports during the last two decades has been accompanied by an unprecedented growth in employment.

While there is no reason to expect that changes in the size of the trade sector will influence aggregate employment, it is a mistake to focus on the employment issue. After all, income and high productivity, not jobs, are the sources of prosperity. Consider the following: if import restrictions are a good idea, why don't we use them to restrict trade among the 50 states? After all, think of all the jobs that are lost when, for example, Michigan "imports" oranges from Florida, apples from Washington, wheat from Kansas, and cotton from Georgia. All of these products could be produced in Michigan. However, the residents of Michigan generally find it cheaper to "import" these commodities. Michigan gains by using its resources to produce and "export" automobiles (and other goods it can produce economically) and then using the sales revenue to "import" goods that would be expensive to produce in Michigan.

Most people recognize that free trade among the 50 states is a major source of prosperity for each of the states. Similarly, most recognize that "imports" from other states do not destroy jobs, at

Figure 4: Employment and Imports as a Share of GDP, 1980-1999

Imports have increased sharply as a share of GDP, as has employment. Changes in imports cause exports plus net foreign investment to change by a similar amount (see Figure 3). Therefore, changes in the volume of imports do not adversely affect total employment.



Source: Haver Analytics.

least not for long. The implications are identical for trade among nations. Free trade among the 50 states promotes prosperity; so, too, does free trade among nations.

Of course, sudden removal of trade barriers might harm producers and workers in protected industries. It may be costly to transfer quickly the protected resources to other, more productive activities. Gradual removal of the barriers would minimize this shock effect and the accompanying cost of relocation.

Myth 4 *"When a high-wage country trades with a low-wage country, the wages of workers in the high-wage country will be pulled down."*

Many Americans believe that if it were not for trade restrictions, American wages would fall to the level of workers in poor countries. How can Americans compete with workers in countries such as Mexico and China who are willing to work for $1 per hour or less? This fallacy stems from a misunderstanding of both the source of high wages and the law of comparative advantage. Workers in the U.S. are well-educated, possess a high skill level, and work with large amounts of capital equipment. These factors contribute to their high productivity, which is the source of their high wages. Similarly, in countries like Mexico and China, wages are low precisely because productivity is low.

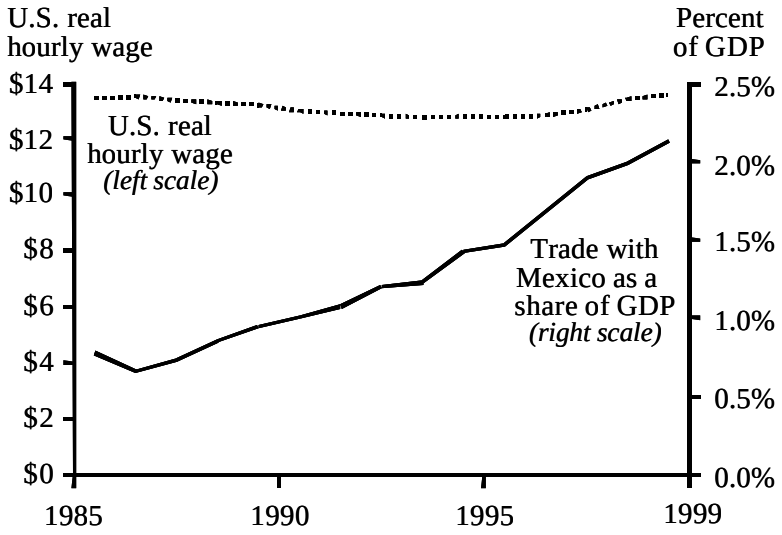
It is comparative advantage that determines which goods will be imported and which will be exported. When resources are directed by relative prices and the principle of comparative advantage, both high- and low-wage countries are able to reallocate resources away from goods and services for which they are high-cost producers and toward those items they can supply economically. Both can gain from specializing in activities they do relatively better. The comparative advantage of low-wage countries is likely to be in the production of labor-intensive goods, such as toys, textiles, and assembled manufactured products. On the other hand, the comparative advantage of the United States lies in the production of high-tech manufacturing products and other goods produced economically by a well-educated labor force.

Thus, trade reflects relative advantage, not wage levels. We recognize this point with regard to domestic trade. No one argues that trade between doctors and lawn service workers, for example, will lead to wage equalization between the two. Because of their different skills and costs of providing alternative goods, both high-wage doctors and low-wage lawn care workers can gain from trade. The same is also true for trade across national boundaries.

If foreigners, including those earning low wages, are willing to sell us a product cheaper than we ourselves can produce it, we can

Figure 5: U.S. Trade with Mexico and Growth of Real Hourly Wages

During the 1990's, U.S. trade with Mexico, China, and other low-wage countries has grown rapidly. There is no evidence that this trade has depressed real wages is the United States.



Source: Haver Analytics.

gain by using our scarce resources to produce other things. An extreme example will illustrate this point. Suppose a foreign producer (perhaps because workers were willing to work for little) was willing to supply us quality automobiles for free. Would it make sense to enact a tariff barrier to keep out the autos? Of course not. Resources that were previously used to produce automobiles could now be freed to produce other goods. The real income and availability of goods would expand. It makes no more sense to erect trade barriers to keep out cheap foreign goods than to keep out free autos.

Myth 5 *"It is sound policy for a country to support a weak industry with subsidies. A liberal interpretation of 'dumping' is necessary to protect domestic industry."*

If a foreign country can supply us with a commodity cheaper than we ourselves can make it, [we had] better buy it off them with some part of our own industry, employed in a way in which we have some advantage.

ADAM SMITH[3]

As Adam Smith noted more than two centuries ago, a nation can gain from trade whenever a good can be acquired from foreigners more cheaply than it can be produced domestically. When foreign governments subsidize their exports to us, they are subsidizing American consumers. Of course, the subsidies are costly to the taxpayers funding them. With time, they are likely to tire from the burden and bring the subsidies to a halt.

If foreigners are subsidizing their producers, some argue we should do the same. This makes no sense. Merely because foreigners are wasting their resources propping up inefficient suppliers is no reason for us to engage in the same folly. As with other trade restrictions, export subsidies will channel more of our resources toward production of things we do poorly and away from things we do well. A smaller output and lower level of income will result. Put simply, neither individuals nor nations can expect to get ahead by spending more time producing things they do poorly.

Similarly, a liberal interpretation of "dumping" in the application of our anti-dumping laws impedes our country's economic growth. The current law provides relief in the form of anti-dumping duties (tariffs) when a domestic industry is injured as the result of a good being sold in the United States at a price below cost or lower than that found in the domestic market of the exporting firm. However, it is not easy to tell whether dumping laws are, in fact, being violated.

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[3] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776; Cannan's ed., Chicago: University of Chicago Press, 1976), pp. 478-479.

The prices charged in the home market generally vary and the costs of the firms charged with dumping are not directly observable. Some express fear that foreign producers might attempt to drive domestic firms from the market and then raise their prices to a higher level. This is unlikely to be an effective strategy. After all, the high prices would soon attract competitors, including other foreign suppliers.

When analyzing the merits of anti-dumping restrictions, it is important to keep two points in mind. First, price cutting is an integral part of the competitive process. When demand is weak and inventories are large, firms will often find it in their interest to offer goods at prices below the average total cost of production. Domestic firms are permitted to engage in this practice. Why should foreign firms be prohibited from doing so? Second, the use of anti-dumping laws to reduce the competitiveness of domestic markets is sure to be contagious. As a few industries are protected from the competition of foreign rivals, others will seek similar treatment. Herein lies the real danger. If we are not careful, anti-dumping actions will soon become simply another, rather thinly veiled, mechanism to stifle competition. Our economy has prospered largely because of our reliance on market allocations and avoidance of this type of favoritism. We must not allow the credibility we have earned to be eroded by myopic policies.

Myth 6 *"A trade surplus is good; a deficit is bad."*

The trade deficit does not belong to any individual or institution. It is a pure statistical aggregate, like the number of eggs laid in the U.S. or the number of bald-headed men living here.

HERBERT STEIN[4]

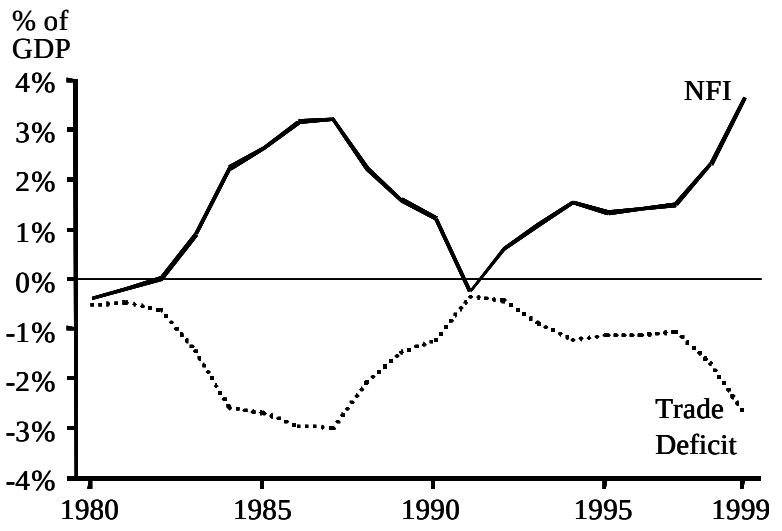
The term "trade deficit" is misleading. "Deficit" generally suggests something bad ¾ like excessive spending relative to income or an overdraft at the bank. A trade deficit occurs when a nation receives more goods and services from foreigners than it supplies to them. What's bad about that? After all, isn't consumption the ultimate objective of economic activity? Conversely, a trade surplus is present when a nation supplies more goods and services for foreigners to consume than it receives from them. What is so good about that situation? Is this something that people will want to continue? A trade deficit is the flip side of a capital account surplus. With floating exchange rates, market forces will bring American purchases of goods, services, and assets from foreigners into balance with sales of these items to foreigners. Thus, a trade deficit will occur when the U.S. economy is offering investors such attractive options that foreigners are investing more in the United States ¾ buying more assets than Americans are investing abroad. Again, it is hard to see what is bad about this situation. Would we prefer that our economy be in such poor shape that investors, domestic as well as foreign, had better options elsewhere?

Doesn't a trade deficit mean greater indebtedness to foreigners? Not necessarily. Much of the foreign investment involves the purchase of stocks and physical assets like buildings and business assets. Americans benefit because they are able to sell these assets to foreigners at more attractive prices than would otherwise be possible. Foreign investments of this type do not increase American indebtedness to foreigners. Some foreign investments are in the form of loans or the purchase of bonds. These transactions

[4] Herbert Stein, "Leave the Trade Deficit Alone," *The Wall Street Journal*, March 11, 1987.

Figure 6: Trade Deficit and Net Foreign Investment as a Share of GDP

Net foreign investment (NFI) and the trade deficit are closely linked. When NFI changes, so too does the trade deficit.



Source: Haver Analytics; *Economic Report of the President*, 2000, b-22.

mean lower interest rates for Americans. If the investments are sound, they will generate a future income stream that is more than sufficient to repay the loans. Even in this case, the loans are helpful to the U.S. economy.

No legal entity is responsible for the trade deficit. It is merely an aggregation of the buying and selling decisions of millions of people. Suppose an American retailer purchases $500,000 of shoes from a British manufacturer. In turn, the British firm uses the funds to buy stocks or bonds issued by an American corporation. These transactions will increase the size of the trade deficit. But why is there any reason for concern? They reflect the voluntary choices of individuals that will both reap the benefits and bear the costs. This is also true for the aggregation of a nation's trade deficit or surplus.

Myth 7 *"A trade deficit is the result of bad economic policy. It indicates that the economy is in trouble."*

Generally, the truth is just the opposite. When the economic environment of a country is attractive to investors ¾ domestic as well as foreign ¾ net foreign investment will be positive and sizeable. This inflow of capital will lead to a capital account surplus. With flexible exchange rates, the capital account surplus will lead to a current account (primarily trade) deficit. Thus, the current account trade deficit is the result of attractive economic conditions generating net foreign investment.

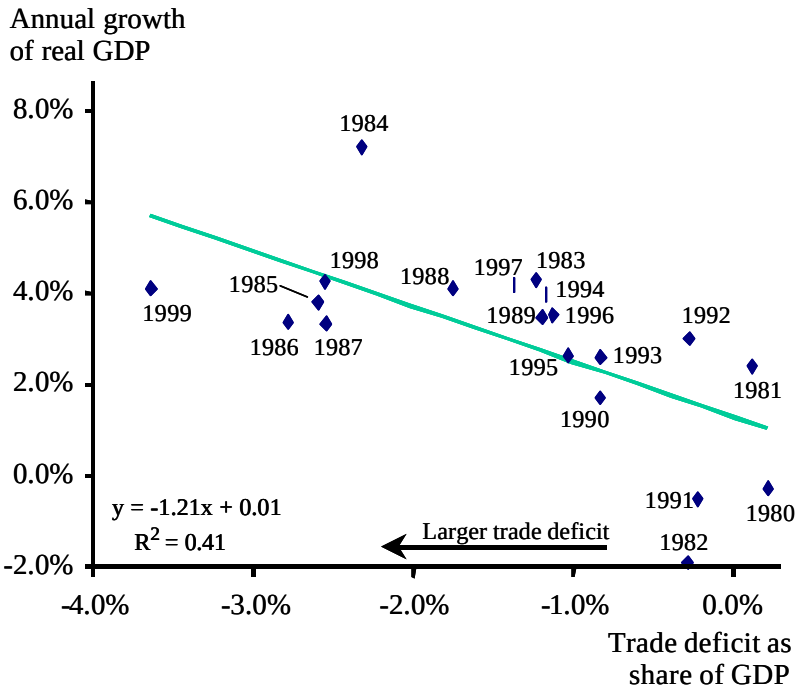
In the case of the United States, there is also another factor at work. Compared to other industrial countries, the U.S. has a low saving rate and more rapid growth of the labor force. The rapid growth of the labor force will enhance both the productivity of, and demand for, capital. Because the saving rate is low, the strong demand will lead to an inflow of capital. Thus, the predictable impact of low saving and rapid growth of employment is an inflow of foreign capital. This situation is likely to continue as long as the U.S. economy provides attractive opportunities for foreign investors. Because the trade deficit is merely the flip side of the capital inflow, it is also predictable that the U.S. will continue to run a trade deficit as long as the economy remains strong.

The balance on goods and services is also influenced by economic growth. Perhaps surprising to some, rapid growth relative to trading partners will tend to enlarge the size of a country's trade deficit (or shift its trade balance from surplus to deficit). The rapid growth of income will stimulate imports, while the sluggish growth of the trading partners will mean weak demand for the country's exports.

Figure 7 illustrates the relationship between economic growth and the trade deficit. Low rates of economic growth are associated with smaller trade deficits. The trade deficit expands as the growth rate increases. Far from indicating economic trouble, trade deficits are often the result of an attractive investment environment and more rapid growth than one's trading partners.

Figure 7: The Trade Deficit and Changes in GDP, 1980–1999

Attractive investment opportunities and rapid growth of GDP encourage both net foreign investment and the growth of imports. This graphic shows how higher rates of growth increase the size of the trade deficit.



Source: Haver Analytics.

Myth 8 *"If trade with another country is fair, our exports to the country will equal our imports from it."*

This statement is totally false. There is no more reason to expect bilateral trade to balance between nations than between individuals. Rather, the predictable result is (a) trade deficits (purchases that exceed sales) with trading partners that are low-cost suppliers of goods and services that we import intensely and (b) trade surpluses (sales that exceed purchases) with trading partners that buy a lot of the things we supply at a low cost.

Consider the trade "deficits" and "surpluses" of a doctor who likes to golf. The doctor can be expected to run a trade deficit with sporting goods stores, golf courses, and favorite suppliers of items like lawn care, plumbing, and auto repairs. Why? The doctor is highly likely to purchase these items from others. On the other hand, the doctor can be expected to run trade surpluses with medical insurers, elderly patients, and those with chronic illnesses. These trading partners are major purchasers of the services provided by the doctor. Furthermore, if the doctor has a high rate of saving, the surpluses will substantially exceed the deficits.

The same principles are at work across nations. A country can expect to run sizeable surpluses with trading partners that buy a lot of the things the country exports, while trade deficits will be present with trading partners that are low-cost suppliers of the items imported. Table 2 indicates the nations with which the U.S. ran the largest bilateral trade surpluses and deficits in 1998. The surpluses were largest with the Netherlands, Australia, Belgium-Luxembourg, Brazil, and the United Kingdom. Do these bilateral trade surpluses indicate that the U.S. treats these countries unfairly? Of course not. The surpluses merely reflect that these countries import goods that American producers supply cheaply. On the other hand, the U.S. ran large bilateral trade deficits with Japan, China, Germany, Canada, and Mexico. Do these countries unfairly discriminate against American goods? The U.S. will tend to run bilateral trade deficits with countries that are low-cost suppliers of goods Americans import intensely. This is the major factor at work here. Interestingly, Canada

and Mexico—two countries that are most open to U.S. products—are among the high-deficit countries.

What about the trade deficit with Japan? Among high-income industrial countries, Japan's trade practices are perhaps the most restrictive. However, this is not the major reason for the U.S. trade deficit with Japan. Japan is a major importer of resources like oil and a major exporter of high-tech manufacturing goods. Americans import a lot of the latter, but they export very little of the former. If the U.S. were a low-cost supplier of energy, its trade balance with Japan would look much different. Major energy exporters including Indonesia, Oman, Saudi Arabia, and the United Arab Emirates all run sizeable trade surpluses with Japan. In addition, the Japanese saving rate is high and its investment abroad is large. As we have already noted, an outflow of capital will mean a trade surplus. In contrast, the U.S. has a low rate of saving. This differential saving rate between the two countries also contributes to the U.S.-Japanese bilateral trade deficit.

Table 2: Top Ten U.S. Trade Surplus and Trade Deficit Countries in 1998

Country	Trade Surplus — *billions of $* —	Country	Trade Deficit — *billions of $* —
Netherlands	11.4	Japan	-64.1
Australia	6.5	China	-56.9
Belgium-Lux.	5.7	Germany	-23.2
Brazil	5.0	Canada	-18.5
United Kingdom	4.3	Mexico	-15.7
Saudi Arabia	4.2	Taiwan	-15.0
Argentina	3.6	Italy	-12.0
Egypt	2.4	Malaysia	-10.0
Hong Kong	2.4	Thailand	-8.2
United Arab	1.7	South Korea	-7.4

Source: Department of Commerce.

Myth 9 *"A country cannot continue to run trade deficits year after year."*

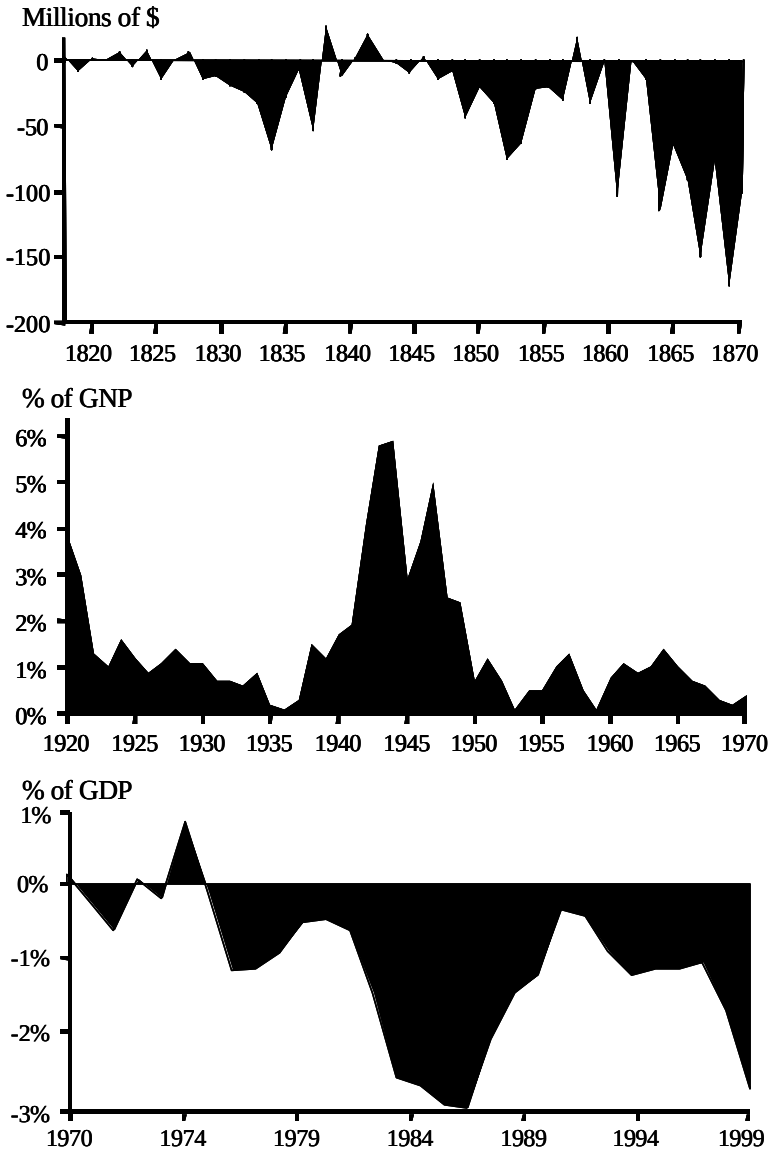
The losses of a business firm must be reversed or eventually they will lead to bankruptcy. Trade deficits are not like that. Not only can a country continue to run a trade deficit year-after-year, but persistent deficits are likely to be the case for a high-growth economy with an attractive investment environment, particularly if the country's saving rate is low.

A trade deficit results when a country's investment exceeds its domestic saving. Net foreign investment will fill this gap. Remember, a trade deficit is the flip side of net foreign investment. As long as the investment opportunities are large enough to provide foreign investors with competitive rates of return, they will be happy to continue supplying the funds. In the case of debt financing, as long as the net income generated by the investment is large enough to cover the borrowing costs, there is no reason why the process cannot continue indefinitely. There are no automatic forces that will cause either a trade deficit or a trade surplus to reverse.

U.S. history illustrates this point. As Figure 8 shows, the U.S. ran trade deficits almost continuously from 1820 to 1870. At this time, the U.S. was a relatively poor (by European standards), but rapidly growing country. Foreign investment helped propel that growth. The situation changed after World War I. The U.S. was richer and investment opportunities were more limited. Thus, trade surpluses were present almost continuously between 1920 and 1970.

During the last 25 years, the situation has again reversed. When considering the significance of the recent trade deficits, it is important to remember that the U.S. has a system of secure property rights, a stable monetary and political environment, and a rapidly growing labor force (compared with Europe and Japan). This makes it an attractive country in which to invest. At the same time, the U.S. saving rate is low compared to our major trading partners. The U.S. trade deficit reflects these factors and it is likely to continue as long as they are present.

Figure 8: Balance of Trade on Goods & Services



Source: Department of Commerce; Haver Analytics.

Myth 10 *"A country that runs a trade deficit loses jobs. A country that runs a trade surplus gains them."*

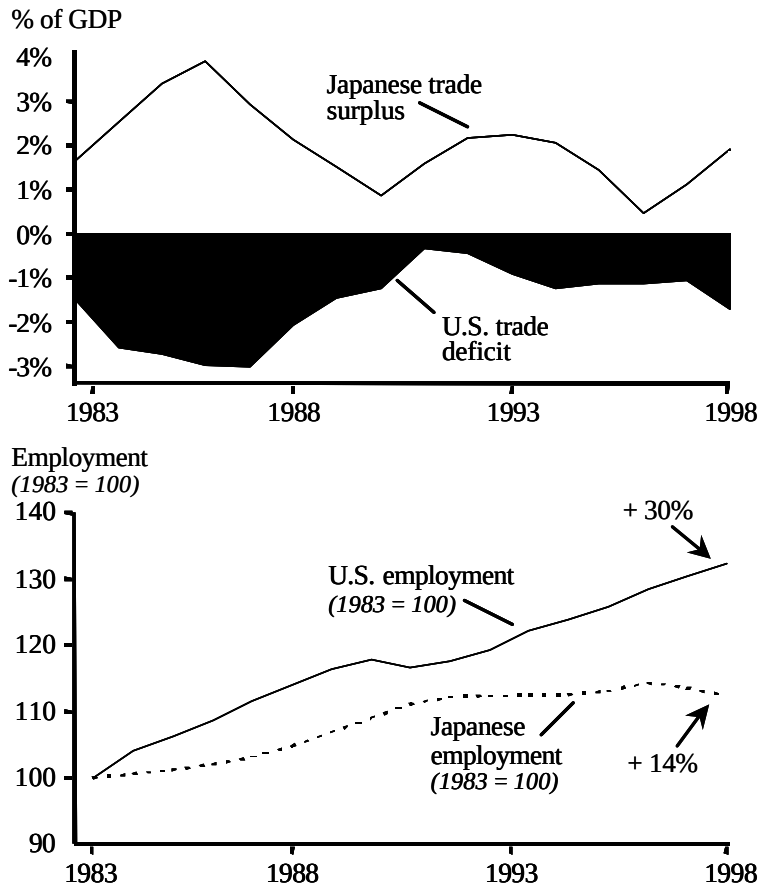
Once again, this view ignores the link between a trade deficit and an inflow of net foreign investment. As Figure 6 (on page 17) shows, net foreign investment is the flip side of a current account trade deficit. You cannot have one without the other, at least not for long. To the extent that a trade deficit (excess of imports over exports) reduces employment, net foreign investment will lead to lower interest rates and stimulate employment. These two factors will offset each other. Thus, there is no reason why a trade deficit will either increase or decrease employment.

The U.S. and Japan provide a test case for this proposition. As the top panel of figure 9 shows, Japan has persistently run a large current account surplus, while the U.S. has persistently run a deficit. But look at the employment growth of the two economies. During the last 15 years (1983-1998) employment in the United States has risen 30 percent. During the same period employment in Japan rose only 14 percent. Even though Japan persistently runs trade surpluses while the U.S. runs deficits, the U.S. experienced the larger employment growth.

According to economic theory, there is no reason to believe that either trade deficits or trade surpluses will exert a significant impact on employment growth. The empirical evidence is supportive of this view.

Figure 9: Trade Balances and Employment: US vs. Japan, 1983-1998

Japan has persistently run a trade surplus while the US has run trade deficits. Nonetheless, US employment growth has been more rapid.



Source: *OECD Economic Outlook #65,* OECD; Haver Analytics; *World Development Indicators 2000,* World Bank.

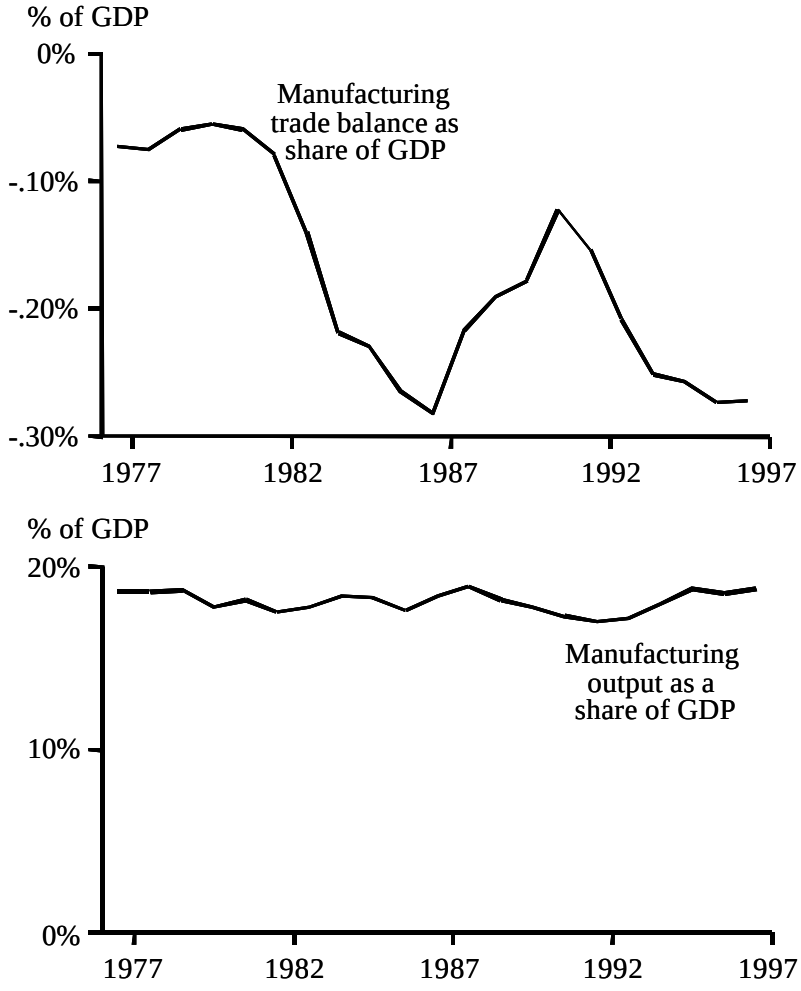
Myth 11 *"Our merchandise trade deficits indicate that the U.S. is de-industrializing"*

The de-industrialization myth stems from the mistaken belief that because manufacturing employment has fallen significantly as a share of total employment, industrial production must be falling as well. But this is not the case. Actually, manufacturing output has been growing rapidly. Since the current string of consecutive trade deficits began in 1976, U.S. manufacturing output has risen 90 percent. As Figure 10 illustrates, manufacturing output has hovered around 20 percent of GDP throughout this period.

If manufacturing output has remained constant as a share of GDP, why has manufacturing employment fallen? Growth of productivity provides the answer. Because productivity growth in manufacturing has persistently exceeded other sectors of the economy, a smaller number of workers is required to maintain manufacturing output as a relatively constant share of total output.

Figure 10: Manufacturing Output and Manufacturing Trade Deficits, 1976-1998

The magnitude of the US manufacturing trade deficit has varied significantly over the past two decades. Nonetheless, manufacturing's share of GDP has remained relatively constant.



Source: *Economic Report of the President,* 1999.

Myth 12 *"Pegged exchange rates are a good strategy. They allow a country to have relatively stable exchange rates while still pursuing an independent monetary policy."*

There are three major types of exchange rate regimes: (1) flexible rates, (2) fixed rates (a unified currency), and (3) pegged rates. The United States and most of the other industrial countries have flexible exchange rates—market forces determine the foreign exchange value of their currencies. The distinguishing characteristic of a fixed-rate, unified currency regime is the presence of only one central bank with the power to expand and contract the supply of money. For the dollar, that central bank is the Federal Reserve.

In addition to the United States, several other countries are also part of the unified dollar system. Panama has essentially adopted the dollar as its domestic currency. Both Argentina and Hong Kong used currency boards to link their currencies to the dollar. None of these countries has a central bank with the power to expand and contract the money supply. They essentially accept the monetary policy of the Fed. The eleven countries of the European Monetary Union recently adopted a fixed-rate, unified system and they will soon have a common currency. Again, this regime will operate with only one central bank that has the power to alter the money supply.

Both flexible and unified-fixed rate regimes avoid persistent problems in balancing supply and demand for money. The regime that leads to trouble is a pegged rate system. Under a pegged rate system, a country commits itself to the maintenance of a specific exchange rate (or exchange rate range) relative to another currency (or a bundle of currencies). However, countries with pegged rates also continue to conduct an independent monetary policy. This leads to problems.

A nation can maintain full convertibility of its currency if it is willing to either (1) follow an independent monetary policy and allow its exchange rate to fluctuate or (2) tie its monetary policy to the maintenance of the fixed exchange rate. However, it cannot maintain the convertibility of its currency at the fixed exchange rate while following a monetary policy more expansionary than that of

the country to which its currency is tied. Inevitably, this is what happens when such a country continues to conduct monetary policy. This regime is a little bit like a blind person walking down an alley with a number of manholes. Things may go smoothly for awhile, but eventually a crisis develops.

In order for a pegged rate system to work, a country must surrender its monetary independence and accept the monetary policy of the country to which its currency is pegged. But this is precisely what nations seeking to peg their currencies are unwilling to do. Eventually, they follow a monetary policy that is too expansionary for the maintenance of the peg, leading to a financial crisis. This is what happened with Mexico during 1994-95. More recently, much the same thing happened in Brazil and several Asian countries (Thailand, South Korea, Indonesia and Malaysia). A pegged exchange rate regime is a bomb waiting to explode.

V. FREE TRADE, INCOME AND GROWTH

The United States is a large free trade zone. This is an important factor that has contributed to the success of all Americans. Just as free trade within the U.S. promotes prosperity, so too, does international trade. When the residents of a country are permitted to buy from suppliers offering the best deal and sell to purchasers willing to pay the most attractive prices, they will be able to concentrate more of their resources on the things they do well (produce at a low cost), while trading for those they do poorly. As a result, they will be more prosperous.

In order to test the linkage between free trade and economic prosperity more rigorously, the staff of the Joint Economic Committee developed a Trade Openness Index. This index measures the degree to which citizens in various countries are free to exchange goods, services, and capital assets with residents of other countries. The index is based on four factors: (1) tariff rates, (2) presence or absence of a black market for foreign currency, (3) size of the trade sector as a share of the economy, and (4) restrictions on capital movements. High ratings are given to countries with low tariffs, no black market for foreign exchange, a large trade sector (given the country's size and locational characteristics), and few restrictions on the inflow or outflow of capital.[5]

It was possible to derive the index for 97 countries for the period 1980-1997. Table 3 lists the countries with the 12 highest and 12 lowest average ratings for openness during this 18 year period. The 12 most open economies had low tariffs, liberal currency conversion policies, large trade sectors, and few restraints on the inflow and

[5] The four components of the index were weighted equally. The country data on tariffs, black market exchange rate premiums, the actual size of the trade sector relative to the expected size, and a categorical rating indicative of capital market restrictions were all placed on a 0 to 10 scale. For details, see James Gwartney and Robert Lawson, *Economic Freedom of the World: 2000 Annual Report* (Vancouver: Fraser Institute, 2000). The expected size of the trade sector is influenced by both country size and location. Thus, the model used to estimate the expected size of the trade sector is adjusted for size of country (population and geographic area) and locational characteristics (length of coastline and distance from concentrations of demand).

Table 3: Trade Openness, Income, and Growth

Most open economies	Trade Openness Index (avg) 1980-97	Real GDP per person 1997	Average annual growth of real GDP per person 1980-97
Hong Kong	9.9	$26,150	4.7%
Singapore	9.8	$30,756	5.8%
Belgium	9.0	$23,763	1.7%
Panama	8.8	$7,521	0.7%
Luxembourg	8.5	$36,190	3.7%
Germany	8.5	$22,693	1.6% *
United Kingdom	8.4	$21,825	1.8%
United States	8.4	$30,610	1.6%
Netherlands	8.4	$22,717	1.6%
Switzerland	8.1	$27,985	0.8%
Malaysia	7.9	$11,274	4.2%
Canada	7.7	$23,272	1.2%
Average	***8.6***	***$23,730***	***2.3%***
Least open economies			
Algeria	3.0	$4,887	-0.9%
Madagascar	3.0	$971	-2.2%
Nigeria	2.9	$935	-0.9%
Argentina	2.8	$10,600	0.4%
Ghana	2.8	$1,913	-0.1%
Syria	2.4	$3,182	1.0%
Uganda	2.4	$1,117	2.2% *
Iran	2.0	$6,206	-0.2%
Burundi	1.4	$646	-1.2%
Sierra Leone	1.4	$538	-3.9%
Bangladesh	0.6	$1,117	2.4%
Myanmar	0.2	$1,287	1.7%
Average	***2.1***	***$2,783***	***-0.3%***

Sources: Trade openness (0-10 scale) derived by JEC staff. Data are from CIA, *Handbook of International Financial Statistics;* World Bank, *World Development Indicators,1999;* IMF, *International Financial Statistics Yearbook, 1999.* GDP per person is in 1998 dollars, derived by purchasing power parity method.

Note: *Data for Germany are for West Germany only prior to unification. Due to data restrictions, Uganda's average annual growth is only since 1982.

outflow of capital. Hong Kong, Singapore, Belgium, Panama, Luxembourg, and Germany head the list; the United States ranks seventh, tied with the United Kingdom and the Netherlands. In contrast, the least open economies—Myanmar, Bangladesh, Sierra Leone, Burundi, Iran, Uganda, and Syria—persistently followed policies that restricted trade.

If trade makes a difference, countries that are open over a long time should both achieve higher levels of income and grow faster. As Table 3 shows, this has indeed been the case. The GDP per person of the 12 most open economies in 1997 averaged $23,730--eight times the average of $2,783 for the 12 least open economies. The 12 most open economies grew, on average, 2.3 percent a year during 1980-97, compared to *minus* 0.3 percent a year for the 12 least open economies. The striking differences in both the income levels and growth rates illustrate the importance of international trade as a source of growth and prosperity.

A more detailed analysis of the 97 countries revealed that there was a strong positive relationship between both (1) openness and per capita GDP and (2) openness and rate of economic growth. Of course, economic performance is influenced by factors other than openness. In particular, institutions and policies that provide for more secure property rights and lead to persistent stability in the general price level are also important. These factors were also integrated into the analysis of the 97 countries in order to determine if openness exerts an independent impact. The results indicated that even after the positive effects of secure property rights and price stability were accounted for, the more open economies had higher income levels and achieved more rapid growth than those that were less open.

VI. CONCLUDING THOUGHTS

The U.S. experience indicates that openness and growth of the trade sector positively impact economic performance. International trade has grown from 13.5 percent of the U.S. economy in 1980 to 27.2 percent in 1999. Capital flows into and out of U.S. markets have grown even more rapidly. While there were some reductions in U.S. trade barriers—particularly on trade with Canada and Mexico—lower transport and communication costs, along with shifts toward more liberal trade policies by other countries, have been the driving forces underlying the growth of U.S. trade.

The unprecedented growth of international trade during the last two decades has been accompanied by:

- Growth of employment from 99 million in 1980 to 133.5 million in 1999, an increase of 35 percent;
- A reduction in the average unemployment rate from 7.3 percent in 1978-82 to 6.1 percent in 1988-92 and 4.9 percent in 1995-99;
- Price increases of both imports and exports that were well below those of the overall price level;
- An 82 percent increase in real GDP;
- Low and steady rates of inflation.

Of course, other factors—particularly the steady monetary policy of the Federal Reserve—deserve much of the credit for the low inflation and stable growth of recent years. But the growth of trade has also exerted a positive role. Economic theory indicates that international trade helps us get more out of our domestic resources. The U.S. experience during the last two decades is highly consistent with this view.

GLOSSARY

Appreciation
An increase in the value of a domestic currency relative to foreign currencies. An appreciation increases the purchasing power of the domestic currency for foreign goods.

Balance on current account
The import-export balance of goods and services, plus net investment income earned abroad, plus net private and government transfers. If the value of the nation's export-type items exceeds (is less than) the value of the nation's import-type items (plus net unilateral transfers to foreigners), a current-account surplus (deficit) is present.

Balance on goods and services
The exports of goods (merchandise) and services of a nation minus its imports of goods and services.

Balance of merchandise trade
The difference between the value of merchandise exports and the value of merchandise imports for a nation. When the imports exceed the exports, a merchandise trade deficit is present.

Balance of payments
A summary of all economic transactions between a country and all other countries for a specific time period, usually a year. The balance of payments reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits).

Capital account
Transactions with foreigners that involve either (1) the exchange of ownership rights to real or financial assets or (2) the extension of loans.

Comparative advantage
The ability to produce a good at a lower opportunity cost than others can produce it. Relative costs determine comparative advantage.

Depreciation
A reduction in the value of a domestic currency relative to foreign currencies. A depreciation reduces the purchasing power of the domestic currency for foreign goods.

Dumping
The sale of a good or service by a foreign supplier in another country at a price below the average total cost of production or the price charged by the supplier in its home market.

Exchange rate
The domestic price of one unit of foreign currency. For example, if it takes $1.50 to purchase one English pound, the dollar-pound exchange rate is 1.50.

Exports
Sales of goods and services to foreign purchasers.

Flexible exchange rates
Exchange rates that are determined by the market forces of supply and demand. They are sometimes called floating exchange rates.

Fixed exchange rate
An exchange rate that is fixed relative to another currency (or bundle of currencies).

Foreign exchange market
The market in which the currencies of different countries are bought and sold.

Import quota
A specific limit or maximum quantity (or value) of a good permitted to be imported into a country during a given period.

Imports
Purchases of goods and services from foreign suppliers.

Net foreign investment
Purchases of real and financial assets by foreigners from Americans minus American purchases of these assets abroad.

Pegged exchange rate system
A commitment to use monetary and fiscal policy to maintain the exchange rate value of the domestic currency at a fixed rate or within a narrow band relative to another currency (or bundle of currencies).

Tariff
A tax levied on goods imported into a country.

Trade deficit
Situation when imports are greater than exports. Sometimes it is used when referring only to merchandise trade. In this manuscript, services, as well as goods, are included in the trade balance figures.

Trade surplus
Situation when the exports of goods and services are greater than the imports of these items.

This staff report was prepared by James Gwartney, Chief Economist to the Chairman; James Carter, Senior Economist; and Chuck Skipton, Economist. It expresses the views of the authors only and does not necessarily reflect those of the Joint Economic Committee, its Chairman, Vice-Chairman, or its members. Contact James Gwartney (202-224-2989) with any questions or comments.