

# DO TRADE DEFICITS MATTER?

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## Introduction

Some things matter whether or not they exist. The Loch Ness monster is one. National trade deficits are another. Trade deficits obviously matter to many people, because (whatever they are) they seem to have significant consequences. They cause problems or create undesirable constraints or compel government policy changes.

It is often extraordinarily difficult, however, to determine the precise consequences of trade deficits, real or alleged. The current U.S. trade deficit, if we have one, provides a good example. Are the problems supposedly associated with it the *causes* of the deficit or its *effects*? One reason we cannot answer that question might be that we cannot agree whether the deficit is already here or merely impending. Has the United States been running a continual trade deficit since 1975, as some reports would have it? Or are we only on the way toward a deficit, as a consequence of our current economic recovery and the lagging recovery of our principal trading partners?

Both claims are made and published. Those who report to alarmed readers that the United States has run a trade deficit in every single month over the past seven years almost never stop to reconcile this "fact" with the equally well-established "fact" that U.S. exports of goods and services exceeded imports from 1976 through 1982 by an annual average of almost \$13 billion.<sup>1</sup> How can a \$90 billion surplus be accumulated by running deficits each and every month?

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<sup>1</sup>In this paper all data on U.S. international transactions are based on the standard Department of Commerce calculations, as reported in numerous official publications. See, for example, the International Statistics section in the monthly issues of *Economic Indicators*.

The explanation, of course, is that the monthly "deficits" are the difference between merchandise exports and imports, while the annual "surpluses" are the difference between exports and imports of merchandise plus services. Now it is essential that the phrase "of course" appear in the above explanation, to avoid any implication that I think I am saying something new or profound by calling attention to the difference between the merchandise trade balance and the balance on goods and services. After careful reflection, however, I want to withdraw the phrase. Let the first sentence of this paragraph stand unblushingly stripped of its fig leaf.

It is quite possible that nothing at all in this paper is new or profound. That in fact is exactly how it appears to me. The entire essay seems to me to be a series of fairly obvious assertions. If I am going to start saying "of course," therefore, I will have to do an awful lot of it, and that would quickly grow tiresome. More importantly, it would disguise the essential point I want to make, which is that we are not thinking carefully or communicating responsibly when we talk about trade deficits. I am therefore going to omit the defensive "of course" in everything that follows, and try instead to be clear. It might even happen that, if I make my position unmistakably clear, some critic will be able to rescue me from error, and show me why those who speak of trade deficits are in fact making sense, not wandering in darkness and confusion.

It isn't only backwoods editors or small-town journalists who treat deficits in merchandise trade as if they were more than they are. The *Wall Street Journal* and the *New York Times* frequently report the Commerce Department's monthly merchandise trade figures in a language of alarm, offering no hint to the reader that the deficits result from a partial accounting.<sup>2</sup> The government's recent forecast of a more than \$100 billion merchandise trade deficit for 1984 was referred to by the *Journal* as "a red-ink total." If they do these things in a green tree, what shall be done in the dry? So let us return to fundamentals to see if we can first agree what it is we are talking about.

We should all be able to agree that any report of a deficit or surplus in a nation's total international transactions is necessarily based on a partial accounting of some sort, for the simple reason that all international economic transactions are treated as exchanges, in which, for accounting purposes, the value of whatever is given up is exactly equal to the value of what is obtained in return. Consequently, the

<sup>2</sup>Readers who want to sample these reports should see the newspapers on the 29th day of any month.

balance of payments always and necessarily balances. If the flow of measured exports exceeds or falls short of the total of measured imports, measuring errors must have occurred—as they are bound to do in any attempt to keep track of the international transactions of 230 million people. The record keepers consequently add the difference to the smaller of the two flows and label it “statistical discrepancy.”<sup>3</sup>

It follows from this that any announcement of a deficit or surplus in a nation’s foreign transactions results from a decision *not to count certain transactions*. Which ones? And why are they excluded? In order to see what might be going on here, we must first turn our attention to one of the most useful and simultaneously most misleading concepts in economics, the concept of *equilibrium*.

### The Concept of Equilibrium

In economic theory, an equilibrium situation is a situation of balance among contending forces. It is a stable situation, in the sense that it can be expected to persist as long as all the contending forces retain their present form. The crucial point to be noticed is that *equilibrium is a concept*, not something that can be observed empirically. Any and every constellation of economic variables is an equilibrium constellation *from some point of view*. After all, any actual situation must be the result of a balance among contending forces, however momentary that balance may be. And every imaginable situation will be an “equilibrium” if we imagine the appropriate circumstances.

The point is much easier to make with concrete examples.<sup>4</sup> Let’s take the common textbook case of government price supports and an equilibrium price for corn. Although economists frequently characterize the equilibrium price as “the price that clears the market,” this cannot be a correct definition since *the market clears at every price*. The quantity of corn purchased is always equal to the quantity sold, whatever the price, because purchases and sales are opposite sides of the same coin.

“Wait a moment,” an economic theorist will object. “The quantities purchased and sold are not the same thing as the quantities demanded

<sup>3</sup>The statistical discrepancy in recorded data for the United States came to \$42 billion in 1982, an amount that swamps any defensible measurement of a deficit (or surplus) for the year. I do not know why this bit of news has so little effect on those who anxiously report on the shifting course of deficits and surpluses.

<sup>4</sup>My argument in this section has been extensively influenced by the perceptive analysis in Steven N.S. Cheung, “A Theory of Price Control, *Journal of Law and Economics* 17 (April 1974): 53–71.

and supplied. It's quite true that purchases will exactly match sales; but sellers might *want* to sell more than purchasers are willing to buy. The quantity supplied at the going price, in other words, might be greater than the quantity demanded at that price—which is what we mean by a disequilibrium. The market only clears when the quantity that demanders *want* to purchase matches the quantity that suppliers *want* to sell."

But notice what this argument implies. It tells us that some demanders or suppliers are behaving differently from the way they want to behave. Isn't that rather odd? If the suppliers of corn want to sell more than they are actually selling, why don't they do it?

"They can't," our hypothetical theorist replies, "because the price is too high."

Then why don't some corn suppliers offer to sell at a slightly lower price, which is what we would predict if the corn suppliers really do want to sell more corn than buyers want to purchase?

"Suppliers don't have any incentive to lower their price," is the rejoinder, "as long as the government stands willing to purchase at the support price all the corn suppliers want to sell at that price."

End of the argument. An equilibrium price for corn, it now emerges, is the price that would clear the market in the absence of a government price support program. It is the price that equates the quantity supplied with the quantity demanded when we exclude from consideration the demand stemming from the Commodity Credit Corporation.

If every situation is taken to be an equilibrium situation, the concept of equilibrium is useless. The usefulness of the concept hinges, therefore, on our ability to specify and distinguish disequilibrium situations. We do this by isolating and excluding some of the forces supposedly at work in the situation under analysis. In the case just argued, the government's demand was excluded in order to focus attention on the factors causing the amount of corn in storage to rise or fall. The exclusion is justified by the purpose it serves. The danger is that we may forget about the purpose that led to the exclusion which defined the disequilibrium, and start pretending that the government-supported price is "really" a disequilibrium price. That's simply nonsense.

Consider another example. Economists frequently claim (I have done it myself) that legislated price controls create shortages by preventing prices from moving to their equilibrium levels. But what do we mean by a shortage? We do not mean a situation in which there isn't enough for all buyers to have as much as they want,

because that describes just about every situation. We live in a world where scarcity is the general rule. When economists speak of shortages, they usually mean situations in which demanders are unable to purchase all that they want to purchase *at the prevailing price*.

But that's not really accurate, either. If demanders cannot purchase as much as they would like to purchase, won't they search for ways to accommodate their preferences more satisfactorily? And won't these efforts raise the price that purchasers must pay, until the quantity demanded comes into line with the quantity supplied? In the presence of effective legal controls on the *monetary* price, the adjustment in response to competition among purchasers will have to occur entirely in the non-monetary components of the buyers' opportunity cost. But those components affect the quantity demanded just as surely as the monetary price affects it. When we speak of "the quantity demanded at the prevailing price," we are really talking about the quantity demanded at the prevailing cost of acquisition, which includes all kinds of non-monetary costs.

The economist's claim that price controls create shortages turns out, therefore, to be the claim that price controls lead to increases in non-monetary costs of acquisition. The "disequilibrium" prices produced by price controls are disequilibrium prices only if we exclude from consideration *changes* in non-monetary components of the purchase price. This exclusion is justified by the economist's desire to isolate these changes and to examine their effectiveness, relative to changes in monetary price, in securing mutual accommodation between suppliers and demanders. We see once again that an analytical intention suggested the exclusion which gave meaning to the notion of a disequilibrium.

*Every claim of a disequilibrium rests upon an analytical exclusion.* It is sometimes important to insist upon this fact, in order to avoid giving the impression that the "problem" with a "disequilibrium" is independent of human purposes. A playground seesaw is in physical equilibrium when a fifty-pound person sits on one end and a two-hundred pound person on the other. Only when we take account of the parties' desire to move up and down can we correctly say that the seesaw is in disequilibrium when the heavy person is on the far end rather than up toward the middle.

With only two parties, intentions or purposes are relatively easy to ascertain; we can therefore usually decide quickly whether or not a seesaw is in disequilibrium and start looking for an equilibrium solution. Can we do the same in the case of an alleged disequilibrium in the balance of international payments?

## Disequilibrium in the Balance of Payments

I think we would be far more suspicious when confronted by any alleged trade deficit if we stopped to realize how much is concealed in such disequilibrium claims. They are often, as Fritz Machlup has argued, disguised political judgments.<sup>5</sup> I happen not to share the horror of political or ethical judgments that is conventionally professed among economists. But *disguised* political judgments are another matter. They violate the imperative of clarity. And lack of clarity in an area where conflicting political interests abound is an invitation to trouble. That is certainly the case when we start talking about trade deficits.

Any claim of deficit or surplus in a nation's trade balance, I have argued, necessarily rests upon a decision to exclude some items when calculating the balance. Which ones? And why are they excluded? We're ready now, after our digression on the equilibrium concept, to suggest an answer. The items excluded will be those which enable the persons alleging a trade deficit (or surplus) to call attention to the problems that concern them.

It must be granted at the outset that most people who talk or write about trade deficits are simply taking over uncritically someone else's definition. They may not know what has been excluded in order to create the deficit; and if they do know, they may have no idea of how the exclusion can be justified. I certainly do not want to be understood as arguing that every journalist, academician, or economist in the Commerce Department is concerned about some particular problem when referring to trade deficits. I am more interested in maintaining that all concepts of a trade deficit harbor concealed concerns and disguised political judgments—concealed and disguised, more often than not, from the very people wielding the concepts.

In the last few years, the deficit most often discussed by the news media has been the merchandise trade deficit. Recorded data indicate that the United States has imported a greater dollar value of merchandise than it has exported in every single month since the end of 1975. But why is that called a deficit? What is significant about the relationship between merchandise exports and imports, taken by itself? I don't know how to answer that question, because I don't think that it has any significance at all, and I don't recall ever encountering an explanation that went beyond vague rhetorical alarms.

<sup>5</sup>Fritz Machlup, "Equilibrium and Disequilibrium: Misplaced Concreteness and Disguised Politics," *The Economic Journal* 68 (March 1958); reprinted in Machlup, *Essays on Economic Semantics* (Englewood Cliffs, N.J.: Prentice-Hall, 1963), pp. 43–72.

It is often suggested or implied that the growing merchandise trade deficit reveals this country's increasing inability to compete internationally with goods manufactured in other countries. But what does this really mean? The inability of General Motors to persuade motorists to buy its automobiles rather than, let us say, Japanese automobiles, probably constitutes a problem for GM's managers, employees, shareholders, and franchised dealers. But how do we know that this demonstrates an increasing inability of "this country" to compete, rather than the ongoing operation of the principle of comparative advantage?

I have learned from experience how difficult it is to persist in this line of argument and be taken seriously. It is simply "obvious" to many people that the United States cannot prosper if our imports of manufactured goods regularly exceed our exports of manufactured goods—as has supposedly been the case for the past seven years and more. I shall pass by the fact that merchandise is not the same as manufactured goods, that the growth of petroleum imports has had far more effect on our merchandise trade balance over the past decade than the dreaded Japanese have had, and that the United States actually exported a greater value of manufactured goods than it imported in both 1980 and 1981, as well as in 1977 and 1979 if we use customs valuations in our calculations. I shall pass by these facts quickly because I fail to see that anything of inherent significance would have been established even if it were true that U.S. exports of manufactured goods had been below imports for each of the past 10 years.

This is not to deny that U.S. firms have often performed poorly in recent years, or that sizeable sectors of the economy are going to diminish dramatically or disappear if major adjustments do not occur in response to foreign competition. What I deny is that comparisons of aggregate merchandise exports with imports provide any kind of help in describing, diagnosing, or prescribing for this situation.

They do, however, provide political arguments that can be used by people who want protection from foreign competitors or subsidies for their efforts to sell abroad. For the existence of a trade deficit implies that the ratio of imports to exports *must eventually decline*, since no deficit can continue forever. So we might as well get on with it now: Fund the Export-Import Bank, restrict imports from nations that interfere with our exports, slap penalties on foreign firms that are "dumping" in our markets, and face up in general to the fact that free trade is good trade only if it is fair trade.

Trade deficits are politically potent weapons because "everyone knows" that "deficits cannot continue indefinitely." Even the federal

government must eventually stop running deficits, or else . . . something fearful will happen. What? Popular opinion is vague about the consequences, but fairly firm in the underlying conviction that “you can’t go on running deficits forever.”

The truth is that the federal government can indeed go on adding indefinitely to its indebtedness, with no assignable limit. It can spend more than it collects in taxes, even without expanding the money stock, so long as it can collect the difference in loans. And it will be able to borrow just so long as and to the extent that people are willing to loan to it. People will be willing to buy and hold government bonds insofar as they think they will be better off owning government bonds than they would be with alternative assets. When the public displays reluctance to hold all the debt that the federal government must issue in order to finance a current deficit, a slight decline in the purchase price of government bonds quickly secures their cooperation. Consequently, the federal government never does operate “in the red”: Total outlays are always matched exactly by total receipts, as long as receipts are defined to include funds raised by borrowing. The concept of a government budget deficit has meaning only insofar as we exclude borrowed funds from the total of government receipts. We might well want to do that, for various analytical purposes. But once again it is the analytical intention that creates the deficit, by specifying what will be excluded from total receipts—which would otherwise necessarily equal total outlays.

For reasons that are unclear to me, this line of argument does not seem to be generally accepted when it comes to discussions about the balance of payments.<sup>6</sup> The data-tenders calculate deficits or surpluses of various kinds with an astonishing lack of attention to what has been excluded in the process. It is no doubt obvious, at least in the Department of Commerce, that the merchandise trade deficit omits services. But to whom is it obvious that something has also been omitted when the data-keepers calculate the balance of trade on goods *and* services? It is not at all obvious, I submit, to some knowledgeable writers for the *Wall Street Journal*, to take just one example.

<sup>6</sup>The *Survey of Current Business* celebrated its 50th anniversary in 1971 with a special issue devoted to a review of the programs of the Bureau of Economic Analysis (then the Office of Business Economics) in the Department of Commerce. Several of the distinguished scholars invited to contribute focused on balance-of-payments accounting. Their comments are illuminating, but they leave the reader—this reader, at least—wondering why the bureau continued afterward to gather, publish, and publicize balance-of-payments data. *Survey of Current Business* 51, no. 7, part 2 (July 1971): 4–22, 33–35, 105–07, and the concluding comments of Bureau Director George Jaszi in his brilliant and witty review of the symposium, 212–13.



The headline on a recent back-page story in the *Journal* (9 August 1983) declared: "As Economy Continues to Revive From Slump, Country's Balance of Trade Grows Sicklier." An accompanying chart, drawn from Commerce Department data, shows net exports of goods and services declining steeply from over \$50 billion on an annual basis in the fourth quarter of 1980 to about \$10 billion at an annual rate in the first quarter of this year, and still headed downward.<sup>7</sup>

It is all quite puzzling. To begin with, why is this called "sicklier"? If surpluses are evidence of health and deficits are signs of sickness, shouldn't the correct description at least have been "less healthy"? But that is still not the basic question. Why should a deficit be regarded in the first place as evidence of economic ill health? We could probably all agree that some events which produce deficits are evidence of matters gone wrong. Short-term borrowing to finance grain imports made necessary by a harvest failure, for example, would push a nation's balance of trade toward deficit as conventionally defined. But the problem here is the harvest failure, not the deficit in the trade balance, and obsession with the deficit that results from the harvest failure obscures the problem.

Not only is the deficit a mere symptom of the problem, it is also a symptom of the problem's resolution. And that's extremely important to keep in mind. The deficit is evidence that funds were made available with which to purchase grain after the harvest failure, and thus to ward off starvation. Isn't the deficit, viewed in this larger perspective, something to welcome rather than to lament? Lamentation is appropriate with regard to the harvest failure; but the deficit is something for which the nation's citizens could properly be grateful.

We are still talking about deficits, however, without deciding what they are. An actual deficit cannot exist in an accounting system that *defines* credits and debits so that they are necessarily equal. Trade deficits must therefore be conceptual phenomena. A trade deficit must be a disequilibrium, not an actual inequality between purchases and sales. And a disequilibrium, we have argued, entails the isolation and exclusion of some factors for purposes of analysis. What do the keepers of the trade balance exclude in order to calculate a deficit or surplus? And why?

They do not offer us an unambiguous answer. Let me therefore suggest on my own that they intend to exclude what we may call "involuntary" transactions. They assume that international exchange includes two distinguishable kinds of transactions. Some are

<sup>7</sup>Alfred L. Malabre, Jr., "As Economy Continues to Revive From Slump, Country's Balance of Trade Grows Sicklier," *Wall Street Journal* (9 August 1983), p. 56.

undertaken for the sake of prospective advantage; people initiate such transactions because they hope to gain something from them. These “autonomous” transactions will ordinarily tend to balance each other off; a nation’s imports will be basically financed by means of its export earnings. Imports and exports, it must be remembered, include services as well as merchandise, and services include both the loan of capital and payments for the use of capital.

Almost inevitably, however, on this view of the matter, the “autonomous” transactions initiated by households, business firms, governments, and other agencies will fail to produce a precise match between debits and credits in each trading nation. The difference will have to be made up by compensating transactions, or what we are calling “involuntary” transactions to indicate that the parties initiating them do not undertake them for the sake of prospective advantage to themselves, but rather to accommodate the actions of others. Thus, if a nation’s financial institutions increase their holdings of deposits denominated in a foreign currency, *not* for the sake of the interest return on those deposits, but rather to compensate for a merchandise net export surplus, that increase in deposits represents a surplus in the nation’s balance of trade (and a deficit for the nation whose liabilities have increased). Deficits and surpluses are calculated, then, by excluding from the totals of export and import transactions all such “involuntary” or merely compensating transactions.

### Some Caveats

This use of the equilibrium concept strikes me as thoroughly illegitimate. To begin with, a distinction between “autonomous” and “involuntary” transactions is hard to draw without abandoning the basic premise of economic theory, that actions represent rational choices under constraint. Moreover, commercial banks clearly do not hold foreign assets in order to square the national trade balance. Nor do central banks! Just what does make central bankers tick is a mystery to many, of whom I am one; but I am confident that no central bank anywhere adjusts the composition of its asset portfolio in order to equate the balance of payments, if for no other reason than that it cannot possibly acquire the information it would need to do so.

The managers of financial institutions, whether private or official, national or international, affect the balance of payments in the same way that ordinary exporters and importers do it: as the consequence of pursuing their own interests in a situation with diverse but limited options. This is not to say that central bankers do not pursue what they regard as the national interest. They well may. But when they

do so, they do *not* do it by aiming at a balance in the balance of international payments. We know this is not their target because we know this is a target they cannot see. They are necessarily aiming at something else if they are "aiming" at anything at all.

Their actual target might be some particular foreign exchange rate, or some rate of growth in a domestic monetary aggregate, or some desired interest rate, or improved relations with influential parties who want central bank intervention in foreign exchange markets, or even the election of a particular presidential candidate.<sup>8</sup> There are many possibilities. And that is the problem. The allegation of a trade deficit amounts to a vague claim that international exchange transactions are out of order and must be set right. The fundamental issues of exactly what is out of order and how it got that way do not have to be addressed. With the problem undefined, the solution is necessarily undefined. A wide variety of actions might be appropriate. Since even experts disagree extensively on just how any particular policy move is likely to affect the long list of important variables in the world of domestic finance and international exchange, the declaration of a trade deficit amounts in practice to a kind of declaration of martial law. What is most dangerous about such a declaration is that it gives government officials a license to subordinate the rule of law and respect for established rights to considerations of political advantage.

I do not want to be misunderstood. I am not now claiming, whatever I might believe, that we would be better off if central banks stayed out of the foreign exchange markets. Nor am I trying to construct an argument for unrestricted international trade. My claim is a much more limited one. It is that whatever the proper role of government might be in affecting the course of international trade, the concept of trade deficits and surpluses or disequilibrium in the balance of payments darkens counsel. It has no agreed-upon meaning. It ought to be abandoned, so that the way can be cleared for more responsible and effective discussion of the issues that concern us.

I have never encountered a case in which the concept of a balance-of-payments disequilibrium was used to interpret an economic problem where the problem could not have been more clearly explicated, in my judgment, by abandoning the concept. What would we substitute for it? Whatever assertion the balance-of-payments concept is

<sup>8</sup>In support of the last possibility, see Lindley H. Clark, "The Odd Couple: Treasury and Fed Try to Reelect Reagan," *Wall Street Journal* (16 August 1983), p. 33.

concealing in each particular case. Every claim of a balance-of-payments disequilibrium can be more accurately and adequately expressed as a prediction, such as "The dollar will depreciate relative to certain other currencies," or "Certain desired imports will not be available unless foreign lenders can be persuaded to extend credit," or "It is going to be increasingly difficult for producer A to sell in market Y," or "Important political support will be secured by imposing quotas on the importation of goods M and N."<sup>9</sup>

## Conclusion

I am uncomfortably aware of the violence that this recommendation does to long-established tradition. The concept of a balance of international payments has been called, by economists far more reputable than I, a significant analytical achievement.<sup>10</sup> I am claiming that it was in fact and from the beginning a conceptual device that concealed more than it revealed. And the trouble with such concepts in the social sciences is that they facilitate the presentation of political arguments in the garb of empirical assertions.

I think Adam Smith was right. "Nothing . . . can be more absurd than this whole doctrine of the balance of trade."<sup>11</sup> It is a concept originally devised and promulgated by merchants in order to promote their special interests under the pretense of protecting the national interest. And a government that tries to watch over the balance of trade has embarked upon a task that is intricate, embarrassing, and fruitless.<sup>12</sup>

<sup>9</sup>At a time when macroeconomic theory is in such unsettled shape, it seems to me more than ever imperative to strive for clarity in our assertions in this area. We all use theory as a shorthand in making empirical assertions, as when we say that "the outfielder missed the fly ball because of the sun." This practice begins to create confusion as soon as relationships "settled" by theory start behaving in ways inconsistent with the theory (or consistent with only *some versions* of the theory). Relevant examples include relationships at the present time between money stock growth rates and interest rates and between foreign exchange rates and relative rates of inflation.

<sup>10</sup>In his *History of Economic Analysis*, Joseph Schumpeter calls the balance of payments "an important datum in the diagnosis of the economic condition of a country and an important factor in its business processes." Against his explicit claim that development of the concept represented a significant analytical advance, I would adduce his own discussion on pages 352–53, including the long footnote 6. Schumpeter's actual discussion seems to me to demonstrate the inherent ambiguity of the concept and its vast potential for buttressing question-begging arguments. Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), pp. 352–53.

<sup>11</sup>Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (Oxford: Clarendon Press, 1976), book IV, chapter III, part II, paragraph 2. The quotation is on page 456 in the Modern Library edition.

<sup>12</sup>*Ibid.*, book IV, chapter I, paragraph 10. See pages 376–77 in the Modern Library edition.