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Trade, Trade Barriers, and Trade Deficits: Implications for U.S. Economic Welfare

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Summary

This report provides an overview of the economics of international trade that may be helpful for consideration of many recurring international economic policy issues. It is intended as a general explanation of mainstream economic principles that may be considered in gauging the economic significance of trade issues as well as the trade-offs inherent in many policy choices. A fundamental tenet of economics is that international trade is a means to a higher standard of living for all trading nations. The post-war era has seen a rapid expansion of trade and the United States has been a major participant in this process both as a trading nation and as a leader in the steady lowering of barriers to trade worldwide. The significant benefit of trade does not come without disruption and cost, however. Gaining the benefit of trade and also treating equitably those hurt by trade is often a difficult public policy issue.

There is recurring congressional concern about the effect of trade on U.S. economic welfare. Current issues include: bilateral and multilateral trade liberalization initiatives, steel dumping, export controls, and the rapidly growing trade deficit. This report provides a brief overview of the economic arguments for free trade, common arguments for trade barriers, and the cause and economic significance of persistent large trade deficits. A central theme is that the economic benefit of specialization and trade is a fundamental aspect of economic life whether for the individual, region, or nation. This benefit is mutual, enriching each trader; moreover the gain from trade can accrue to a trading partner even if that partner is less efficient in the production of all tradable goods. Trade can also lead to economic gains by allowing a fuller use of economies of scale and by inducing productive innovation. Trade is, however, a disruptive force as well, advancing the economic position of relatively efficient activities, but deteriorating that of relatively less efficient activities. This process will often place significant economic and social costs on workers and industries in adversely affected activities.

Arguments for trade barriers come in many forms but none is generally accepted by economists. Trade barriers are often seen as a redress to the social and economic costs of trade or as a way of enhancing economic advantage. In most cases, however, economists argue protection from trade imposes costs on the economy that exceed the benefits obtained. These costs can arise from inefficient resource allocation, intractable implementation, and foreign retaliation.

The trade deficit is not a necessary aspect of trade, nor is it caused by foreign trade barriers. A trade deficit is rooted in macroeconomic behavior at home and abroad. The deficit is a means for the nation to spend beyond current production, with a like sized inflow of borrowed foreign capital that funds the added spending. Spending beyond current production, particularly on investment, can confer significant benefits. But, borrowing will entail some level of cost as debts are repaid.

The report will be updated infrequently with changes in economic knowledge and with current trade data.

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The Growing Importance of Trade to the U.S. Economy

The American economy has experienced steady and substantial growth of international trade since the end of World War II. Total trade (the combined value of exports and imports) as a share of gross domestic product (GDP) has risen from around 10% in the1950s to more than 25% in 2002. Even this large increase may understate the rising impact of trade on the economy because of the large share of services output, much of which is *non-tradable*, in U.S. GDP. For example, looking at merchandise exports as a share of total *tradeable* output for the U.S. we see growth from near 4% in 1950 to over 40% in 2002. For the United States, however, international trade is still much less important than in other industrial economies, where, as in most European countries, trade often exceeds 50% of GDP.[1]

The rising integration of the American economy with the world economy has been facilitated by technical advances that have reduced the natural barriers of time and space that separate national economies. Integration has also been facilitated by recurrent multi-national policy actions that have steadily lowered various man-made barriers to international exchange. The United States has always played a leading role in pursuing these trade liberalization initiatives. As natural and man-made barriers have fallen, the considerable economic advantages of trade have induced large increases in the international exchange of goods, and a mutual gain in the economic well being of trading nations.

Why Do Countries Trade?[2]

Trade occurs because it is *mutually enriching*, with a positive economic effect like that caused by technological change, whereby economic efficiency is increased, allowing greater output and consumption from the same endowment of productive resources. One can think of international trade as a productive process, with our exports as the inputs and our imports as the output. But, most importantly, it is a more efficient productive process that provides American consumers with goods and services they want at a lower cost than can domestic producers. The notion "exports

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[1]See International Monetary Fund, *World Economic Outlook*, June 2003.

[2]For a fuller discussion see: N. Gregory Mankiw, *Principles of Economics*, (Dryden Press. New York. 1997), pp. 45-57.

are good and imports are bad," often colors public policy debates about international trade. As the cited analogy suggests, from a macroeconomic perspective both exports and imports are "good." We are exchanging something of value to acquire something of greater value to us. And what we gain from such exchange is increased by anything that allows us to exchange a smaller volume of exports for any given volume of imports (i.e. by a reduction in the export price of imports).

Like technological change and other market forces, international trade creates wealth by inducing a reallocation of the economy's scarce resources (capital and labor) into relatively more efficient activities and away from less efficient activities. Such reallocation can be characterized as a process of "creative destruction" generating a net economic gain to the overall economy, but also being disruptive and costly to workers in adversely affected industries. They will likely bear significant adjustment costs and find a diminished market value for their economic services. While economic analysis most often indicates that the economy-wide gains from trade exceed the costs, the perennially tough policy issue is how to secure those gains for the wider community while dealing equitably with those who are hurt by the process.

Specialization, Comparative Advantage, and Gains from Trade

The importance of the *gains from trade* is clearly evident in our individual economic behavior. Rather than build our own automobile, provide our own medical services, or produce our own food, we find it far more efficient to specialize in the production of some good or service we are good at and trade these (indirectly with the use of money) for most other goods or services that we want. Such specialization and trade clearly allow each of us to consume far more than we could if we tried to be completely self-sufficient. The same is true for a country, albeit to a less extensive degree in most cases (i.e., U.S. imports amount to about 15% of GDP).

Economics also tells us that the gains from specialization and trade are mutual, occurring even if the trading parties have an absolute advantage or disadvantage in the efficiency with which they produce *all* tradable goods. All that is required is a difference in relative efficiency, that is, a difference among countries in the rate at which the output of one good must be curtailed to expand production of another good. (In other words, a difference in *opportunity costs* exists). If these rates are different, then each country has a *comparative advantage* in the production of one of the goods, creating the potential for gains from trade. In this circumstance, each country can improve its economic well-being by *producing what it does (relatively) best and trading for the rest.* A nation does not compete with its trading partners, it engages in mutually beneficial exchange with them. Therefore business metaphors such as "competitiveness" that are relevant to the individual firm are unlikely to be useful in understanding the nature and significance of a nation's gains from trade.

This principle of comparative advantage would explain, for example, why the $200 per hour attorney, despite being able to type very fast and accurately, would still find it more efficient to employ a secretary for $25 an hour to do that job. The income gained from using the time he would spend typing to practice law would likely more than compensate for the cost of the secretary. (The opportunity cost of the attorney typing for one hour exceeds the cost of the using a secretary for that task.) Similarly, the secretary gains by spending more time typing and less time attempting to practice law. (The pay from typing exceeds the opportunity cost of not practicing law.)

Differences in comparative advantage will arise between countries because of differences in the relative abundance or scarcity of the factors of production. Comparative advantage will be found in those activities that make intensive use of the abundant productive resource. For example, compared to many other countries the United States, with a relative abundance of high-skilled labor, will find that specialization in the production of goods that use high-skilled labor intensively will, with trade, raise national income. In contrast, China, which has a relative abundance of low-skilled labor and relative scarcity of high-skilled labor, would find that specialization in the production of goods that use low-skilled workers intensively would, with trade, raise that country's real income. (Differences in productive technology among countries could also create differences in relative efficiency and form a basis for trade.)

It is important to highlight that the gains from trade will most often arise from there being *differences between the trading partners*, not just economic differences but social, political, geographical, or demographic differences can be of significance as well.[3] This explains why many economists do not find useful the sports metaphor commonly used in trade policy discussions — the need for a "level playing field" among trading partners. If each person, region, or country were alike in every way there would be little to gain from trading. This observation may be particularly important when considering the merits of U.S. trade with poorer, less economically advanced countries, who will very often have sharply different economic, cultural, and other characteristics. Economic theory indicates that using these differences to generate trade will be an important means by which a rich or poor nation can improve its economic well-being.

Other Sources of Gains from Trade

Trade is also enriching to the extent it allows countries to take greater advantage of *economies of scale.* The longer a production run, the lower unit production costs may be. Many products require huge initial investments in research and development as well as large investments in a highly specialized physical plant and equipment. The ability to reach a larger world market through international trade can greatly reduce average production costs and the final price consumers must pay for the product.

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[3]The exception would be a difference caused by a man made barrier to trade, such as a tariff. In this case, removal of the "difference" through elimination of the tariff would increase the gains from trade and economic well-being.

In addition, expanding international trade can increase the *flexibility* of an economy. Trade can enhance an economy's ability to respond quickly and efficiently to rapidly changing economic conditions in the global market place by improving access to foreign markets, resources, and technologies.

Further, trade can increase the *competitive pressures* in the market place, pushing firms to cut waste, keep prices down, and raise quality. Such pressure can also be an effective check against the use of monopoly power and in general a clear benefit to the nation's consumers.

Finally, trade can accelerate the pace of *technical advance* and boost the level of productivity. By raising the expected rate of return to successful innovation and spreading research and development costs more widely, trade can propel a higher pace of innovation. With more competitive pressure firms must quickly adopt new practices, or risk business failure. Greater international trade can also enhance the exchange of technical knowledge among countries as human and physical capital may move more freely. Economic theory suggests that these inducements will increase an economy's *rate of growth*, causing an increase in income that gets steadily larger as time passes.[4]

Measuring the Gains from Trade

Through these several forces, economists reason that expanding international trade will raise the efficiency of the world economy and improve the living standard of most trading nations. Moreover, these gains are permanent, accruing to the economy each year, and making their full significance better measured by a cumulative gain over the stretch of decades. In the postwar era international trade worldwide has grown three times as fast as a briskly advancing world output, leaving little doubt that trade has made an important contribution to the growing prosperity of the United States and the world economy. Initiatives such as the creation of the European Union, implementation of Uruguay Round of market openings, and the North American Free Trade Agreement (NAFTA) all speak to the importance of trade. It is also apparent that trade has played an important role in the dramatic transformation of the emerging economies in East Asia.

While it is often difficult to precisely isolate the full effect of these several causes of the gains from trade on national income, many studies have measured the benefits to be sizable, with the gain typically growing with the degree of openness to international trade. For example, a 1999 study by Frankel and Romer looked at data from 123 countries to assess the relationship between openness to trade and the growth of real per capita income. They found that each percentage point increase in

[4]Another possible benefit of more open trade for the United States can arise because our level of trade barriers is already very low relative to most other trading partners. Therefore, a removal of those barriers would likely have a stronger positive effect on the demand for our exports than it will on our demand for imports. This can cause a rise in the relative price of our exports. A rising export price will increase the import purchasing power of any given *volume* of U.S. exports and increases the gains from trade to the United States.

openness (as measured by the sum of exports and imports as a percentage of GDP) led to a 0.34 % increase in real per capita income. For the United States between 1960 and 1997, there was a 12.7% increase in *openness* to trade and an associated 4.3% increase in real per capita income, and they expected this gain to increase as the time period is extended into the future.[5]

The Economic Effect of Trade Barriers[6]

If international trade is economically enriching, imposing barriers to such exchanges will prevent the nation from fully realizing the economic gains from trade and must reduce welfare. Protection of import-competing industries with tariffs, quotas, and non-tariff barriers can lead to an over-allocation of the nation's scarce resources in the protected sectors and an under-allocation of resources in the unprotected tradeable goods industries. In the terms of the analogy of trade as a more efficient productive process used above, reducing the flow of imports will also reduce the flow of exports. Less output requires less input. Clearly, the exporting sector must lose as the protected import competing activities gain.

But, more importantly, from this perspective the overall economy that consumed the imported goods must also lose because the more efficient production process — international trade — cannot be used to the optimal degree, and, thereby, will have generally increased the price and reduced the array of goods available to the consumer. Therefore, the ultimate economic cost of the trade barrier is not a transfer of well-being between sectors, but a permanent net loss to the whole economy arising from the barriers distortion toward the less efficient the use of the economy's scarce resources.

The United States and other nations have made great progress in the post-war era in reducing trade barriers. The average tariff among industrial nations has been reduced from near 50% after WW II to near 5% today.[7] Barriers in many developing economies have also fallen but are still generally higher than those of the industrial economies. These remaining impediments to trade, nevertheless, have significant economic costs. A 1994 estimate of the economic cost of existing U.S. barriers in

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[5]Jeffery Frankel and David Romer, *Does Trade Cause Growth?* (NBER Working Paper No. 5476, June 1999).

[6]Man-made trade barriers come in several forms. Two common manifestations are tariffs and quotas. Tariffs are a tax on imported goods. Quotas are a limit on the quantity of a good that can be imported. A variant of the quota is the voluntary export restraint (VER), where the exporting country imposes the restriction. Other forms of barriers (often called non-tariff barriers) include: local content requirements, national procurement policies, and unduly protracted health, safety, and customs procedures. The magnitude of the negative effect on economic welfare will likely vary with the type of barrier used. In general, for a given level of protection quota-like restrictions carry a greater potential for reducing welfare than do tariffs. For a fuller discussion of the nature and implications of different forms of trade barriers see: W. M. Corden. *The Theory of Protection.* (Oxford, Clarendon Press, 1971).

[7]OECD, *Indicators of Tariff and Non-tariff Barriers*, Paris, various issues.

21 highly protected sectors was $70 billion per year, with economic cost per protected job ranging from $100,000 to more than $1 million and average about $170,000.[8] In all 21 cases the cost of protection was far higher than the workers average annual earnings and far higher than any likely worker adjustment program would cost.

The issue, however, is not just whether to continue removing barriers but whether to resist the erection of new barriers. During most of the first half of the 20th century trade barriers grew sharply, reversing the substantial trade liberalization achieved in the previous century. Therefore, much of the effort towards free trade in the post-war era has involved reversing protectionist structures erected beginning at the time of World War I and continuing into the 1930s.

Common Arguments for Trade Barriers

Demands for the preservation or augmentation of trade barriers continues to be part of the public debate over trade policy. Five of the more common arguments for trade barriers are evaluated below for their likely economic effects.

Jobs Are Destroyed by Trade.

It is asserted that trade has created jobs for foreign workers at the expense of American workers. Trade both creates and destroys jobs in the economy just as other market forces do. Economy-wide, trade creates jobs in industries that have comparative advantage and destroys jobs in industries that have a comparative disadvantage. The economy's composition of employment changes, but according to economic theory there is no *net* loss of jobs due to trade. Over the course of the last economic expansion, from 1992 to 2000, U.S. imports increased nearly 240%. While over that same period total employment grew by 22 million jobs and the unemployment rate fell from 7.5 % to 4.0% (the lowest unemployment rate in more than 30 years.)[9]

There is no denying that with international trade there will be short-run hardship for some, but economists maintain the whole economy's living standard is raised by such exchange. They view these adverse effects as qualitatively the same as those induced by purely domestic disruptions such as shifting consumer demand or technological change. In that context, economists argue that easing adjustment of

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[8]See Gary Clyde Hufbauer and Kimberly Ann Eliott. *Measuring the Costs of Protection in the United States.* (Washington, Institute for International Economics, 1994).

[9] These data can be found in the most recent annual report of the Presidents Council of Economic Advisers. Since the end of the recession in late 2001 the labor market has responded slowly, with the unemployment rate continuing to rise even as economic growth strengthened. Relatively weak aggregate spending, caused by a number of recent economic shocks, is the most likely cause of poor employment growth. For a fuller discussion see: CRS Report RL32047, *The "Jobless Recovery" From the 2001 Recession: A Comparison to Earlier Recoveries and Possible Explanations*, by Mark Labonte and Linda Livne.

those harmed is economically more fruitful than protection given the net economic benefit of trade to the total economy.

Worker Wages Are Hurt by Trade.

Many people believe that imports from countries with low wages has put downward pressure on the wages of Americans. There is no doubt that international trade can have strong effects, good and bad, on the wages of American workers. The plight of the worker adversely affected by imports comes quickly to mind. But it is also true that workers in export industries benefit from trade. Moreover, all workers are consumers and benefit from the expanded market choices and lower prices that trade brings. Yet concurrent with the large expansion of trade over the last 25 years, real wages (i.e. inflation adjusted wages) of American workers grew more slowly than in the earlier post-war period, and the inequality of wages between the skilled and less skilled worker rose sharply. Was trade the force behind this deteriorating wage performance?

Economic analyses indicate that it is very unlikely that growing international trade has had much to do with the slowdown in real wage growth and unlikely that trade has caused more than a minor share of rising wage inequality. In the United States, the slower productivity growth evident from the mid-1970s to the mid -1990s is seen as the principal cause of slow real wage growth in this period. The experience during the 1992-2000 period shows that despite a rapidly rising level of imports real hourly earnings in the U.S. manufacturing sector (the sector most strongly effected by trade but one with relatively high productivity growth in this period) rose 26%[10]. For trade to have reduced the relative wages of lower skilled workers there would need to be an associated fall in the market price of those import competing goods that are produced using lower-skilled workers intensively. This has not occurred.[11]

A more likely reason for increased wage inequality is the presence of a bias in recent technological change toward greater use of higher skilled workers economy-wide, tending to pull up their wages relative to those of the less skilled. Other factors that are thought to have made minor contributions to wage inequality are immigration, deunionization, and a falling real minimum wage.[12]

National Security Is Threatened by Trade.

Some industries, or at least components of some industries, are vital to national security and possibly may need to be insulated from the vicissitudes of international market forces. This determination needs to be made on a case-by-case basis since the claim is made by some who do not meet national security criteria. Such criteria may also vary from case to case. It is also true that national security could be

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[10]BLS data as reported in the 2003 Economic Report of the President, p.376.

[11]See: Robert Lawrence and Matthew Slaughter. *International Trade and the American Worker: Giant Sucking Sound or Small Hiccup? Brookings Papers on Economic Activity*, (Washington, Brookings Institution, 1993)

[12]For further discussion see CRS Report 98-441 E, *Is Globalization the Force Behind Recent Poor U.S. Wage Performance?: An Analysis*, by Craig K. Elwell.

compromised by the export of certain *dual-use* products that, while commercial in nature, could also be used to produce products that might confer a military advantage to our adversaries. Controlling such exports is clearly justified from a national security standpoint; but, it does come at the cost of lost export sales and an economic loss to the nation. Minimizing the economic welfare loss from such export controls hinges on a well-focused identification and regular re-evaluation of the sub-set of goods with significant national security potential that should be subject to control.

Infant-Industries with Unique Economic Potential Will not Mature without Protection from Trade.

In theory there can be industries with special attributes whose ultimate contribution to economic welfare justifies shielding them from international competition long enough for them to become competitively viable. In practice, however, identifying such enterprises is likely to be very difficult. It would require the government to evaluate future profitability, to in effect pick economic "winners." This is not a task that government is likely to be very good at and is process that invites significant inefficiency. It is also often the case that the *infant* never grows up in that what was intended to be temporary public support often becomes permanent. One might ask, if the case for long-run profitability of an emergent industry is so compelling, why is the private market overlooking these prospects? Also, our trading partners may up the cost of such protection by retaliating to protect their *special industry* with a barrier of their own, tending to further reduce trade and economic welfare. Recent manifestations of this argument for trade barriers have been called *industrial policy* and *strategic industries policy*. Economic analysis of such policies has left considerable doubt as to their efficacy for raising economic welfare.[13]

Unfair Competition Undermines the Benefits of Trade.

Can trade be beneficial if all parties don't abide by the same rules and regulations? Economic theory says it can. If another country chooses to give a subsidy to an exporting industry, buying those now cheaper exports will hurt domestic industries that compete with those foreign goods, but it will benefit the domestic consumers who purchase them. Economists assert that the gain to consumers will typically exceed the loss to producers and workers. Therefore, from the standpoint of overall economic welfare, here defined as increased national income, an efficient economic response may be to accept the gain in real income offered by the subsidized foreign goods and facilitate the adjustment of the adversely affected home workers to more efficient endeavors.

Similarly, many economists see a possible economic advantage of buying foreign goods produced under different labor and environmental standards. They view differences in such standards as a basis for creating comparative advantage and realizing mutual gains from trade. In addition to the economic benefit to the U.S.

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[13]See Paul Krugman and Maurice Obstfeld. *International Economics: Theory and Policy* (New York, Harper-Collins, 1994). Pp. 187-196.

economy, for many poor nations the ability to use such advantages to produce a tradeable good today may offer the best vehicle to increased productivity and a steadily rising living standard in the future. Despite the economic gain to the United States, trade on this basis can undermine long held domestic norms of "fair" market conduct. It is at the core of many domestic disputes regarding trade and trade barriers as many see trade as eroding labor and environment standards. If deviation from these norms is unacceptable in domestic transactions, it may be hard to justify them in international exchanges.

Yet it is also probably unrealistic to expect our trading partners to be just like us in these practices. Poor countries with much lower levels of productivity simply cannot afford the American level of wages and labor standards.[14] Rich or poor, other countries often have different social and economic priorities and may choose to live with very different environmental standards. One thing that is clear from the economic history of the now rich industrial nations: With rising income there also came rising labor and environmental standards. It can be plausibly assumed that many now poor countries will follow a similar path, and that trade can be an important means for achieving higher income.

Another common activity widely seen as an unfair trade practice is foreign dumping of exports.[15] Dumping can hurt particular workers and firms and is not acceptable under U.S. law. But, for total economic welfare to be reduced by dumping one has to accept the premise that there can be a price that is too low. Price cutting is a basic element of competition, widely practiced in the domestic economy, that leads to greater efficiency and economic gain to consumers. Actions to prevent dumping curtail the benefit of such competition in international commerce. An exception would be instances of dumping that are "predatory" and part of a plan to establish monopoly power. Such predatory practices would ultimately reduce economic welfare and preventing them is in our economic interest. Because predatory pricing is rare, economists place little merit in most claims of dumping. Nevertheless, the number of antidumping actions has risen precipitously in the last 15 years. Once the protectionist tool of choice of a few rich nations, antidumping actions are now being emulated by many other nations.

The discussion so far shows that mainstream economics gives little reason to expect that deviations from free trade improve a nations economic well-being, yet trade barriers persist. This most likely occurs because barriers have very focused benefits accruing to well defined groups with a concentrated political voice, while the barriers costs are often widely dispersed over the population among people with less natural cohesion and a more diluted political voice. Economics analysis demonstrates that the protected groups gain, however, is most often at the greater

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[14]See: Stephen Golup, *Does Trade with Low-Wage Countries Hurt American Workers.* (Federal Reserve Bank of Philadelphia, 1998)

[15]For a fuller discussion, see CRS Report RL31468, *Dumping of Exports and Antidumping Duties: Implications for the U.S. Economy*, by Craig K. Elwell.

expense of the wider community[16]. The tough policy question is finding an acceptable reconciliation of the conflicting goals of improved economic efficiency that comes with open trade and social equity that is often compromised by more open trade, without necessarily relying on trade barriers.

In the post-WW II era most large market economies have prospered, but they have also maintained a "social bargain," whereby, society is asked to embrace the wealth building power of the open market economy in return for an acceptable degree of cushioning from the periodic social disruption and cost that also comes with that process. In effect workers in these economies have been given an amount of *social insurance* to ameliorate the risk to job and income inherent in the operation of markets. Extending this idea, the case can plausibly be made that with more open trade that risk increases and a commensurate enhancement of that social insurance is called for.

Thus to secure the economic benefits of reduced trade barriers and more open trade societies may, in the interest in economic equity and social cohesion, extend and improve that social insurance. This would point toward government policies to better provide for temporary support of income, to better provide for worker retraining, and to better provide for geographic mobility.[17]

The persistence of trade barriers is also a consequence of the slow, incremental process which the world's economies have used to reduce those barriers. While a unilateral reduction or removal of a nation's trade barriers would most often improve its economic well-being, it is rarely used.[18] The steady reductions of tariffs and other trade barriers by the world's economies over the last 60 years was largely achieved by successive rounds of multilateral reductions. Since WW II there have been eight major multilateral trade agreements, the most recent being the Uruguay Round which was completed in 1994.[19] This is a slow process with each round taking many years to negotiate and implement a partial reduction of existing barriers. Yet it is a process that confers significant advantages, not likely to occur with unilateral action. First, the economic gains are likely to be considerably larger if all economies reduces their barriers, because gains arise from the freer flow of both imports and exports. Second, multilateral action gets exporters on board with consumers to broaden political support for the market opening process. And third, the multilateral process develops

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[16]See: Hufbauer and Eliot, op.cit.

[17]For a discussion of striking a balance between fairness and free trade see: Dani Rodrik,. *Has Globalization Gone too Far?* (Institute For International Economics, Washington. 1997).

[18] There are plausible scenarios where nations, if left only with the use of unilateral action, might see their best option to choose protection, while in a multilateral framework they would see that a better result comes from choosing mutual barrier reduction. Thus the use of the multilateral option would reduce the risk of trade wars. This is an example of a situation with the "prisoners dilemma," where individual action always leads to an outcome inferior to the outcome from collective.

[19]Preliminary negotiations called the Doha Development Agenda have occurred to set the stage for the initiation of a ninth round of multilateral negotiations to achieve further reductions of trade barriers world-wide.

an institutional framework for dispute settlement that better insures that once reduced barriers stay down, and institutional momentum that keeps the trade liberalization process moving forward through successive rounds.

The Trade Deficit[20]

The U.S. trade deficit has risen steadily since 1992.[21] It reached $504 billion in 2002, doubling in size since 1998, and with a cumulative rise of about $450 billion since 1992. As a share of GDP the trade deficit has reached a record 4.9%. In the 1990s the trade deficit grew despite good export sales in those years. The 2001 recession reduced the trade deficit, but with economic recovery it has grown larger and economic projections point to the trade deficit continuing to grow this year and beyond assuming the economic expansion gains momentum. But, it is not necessary that an economic expansion generate a large trade deficit.

A Saving — Investment Imbalance

A trade deficit does not occur because U.S. exports may face high foreign trade barriers or because foreign exports are being "dumped" in the U.S. market. Nor does the trade deficit exist because American industry and workers are unable to produce goods that can compete on world markets. The global trade deficit is largely reflective of underlying macroeconomic conditions at home requiring more imports than exports to meet current domestic demand. In effect, the economy spends more than it produces, and the excess of demand is sated by a net inflow of goods and services — a trade deficit. Of course, for this to occur there must be at least one other economy that produces more than it spends at home, and that excess supply becomes a net outflow of goods and services — a trade surplus.

For the United States this phenomenon has its roots in changes over recent decades in both private and government spending/saving behavior. In the last half of the 1990s very strong rates of spending on domestic investment far exceeded the flow of domestic saving available to finance it.[22] A net inflow of foreign savings, relatively abundant due to widespread economic weakness abroad, has filled this gap.

But, what we borrow from abroad is denominated in other currencies and can only be spent abroad. Thus a necessary counterpart of that net inflow of financial

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[20]For a fuller discussion see CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Cures,* by Craig K. Elwell.

[21] The trade deficit measure used here is the "current account balance." This is the nation's most comprehensive measure of international transactions.

[22]See CRS Report No. 98-580, *Saving in the United States: Why Is It Important and How Has It Changed?,* by Brian Cashell and Gail Makinen. Domestic saving is comprised of private (business and households) and public (government) saving flows.

capital is a commensurate net inflow of foreign goods — the trade deficit.[23] The exchange rate acts as the equilibrating mechanism, which, until recently, for the United States has meant a steady appreciation of the dollar. The recent depreciation of the dollar suggests that the size of the net inflow of capital to the United States may be ebbing, most likely due to some reduced attractiveness of the American economy to foreign investors in the wake of recession, slow recovery, corporate malfeasance, and war. Whether this trend will continue is problematic, as the prospect of accelerating growth in the U.S., weak growth abroad, and large federal budget deficits could restore the relative attractiveness of the U.S. economy for foreign investors.

So long as domestic saving in the United States falls short of domestic investment and an inflow of foreign saving is available to fill all or part of the gap, the United States will run a trade deficit. The saving-investment balance suggests two ways the trade gap can be closed. One, the inflow of foreign savings dwindles, forcing domestic investment down toward the level of domestic savings. Or two, the level of domestic savings rises and curtails the attraction for foreign saving and shrinks the associated trade deficit. A lower rate of domestic investment is not desirable, but would follow if foreign investors become less willing to invest in the United States. The alternative of raising domestic savings has more economic merit; but, is problematic. Recent budget surpluses did raise public saving inflows, but budget deficits are likely to be the rule for the foreseeable future, tending to decrease national saving and increase the trade deficit. The private saving rate is low, not easy to influence by policy levers, and not a highly probable source of increased domestic saving flows.

The Benefits and Costs of Foreign Debt

A trade deficit is not necessarily undesirable. Increasing current spending beyond current means need not be imprudent behavior. Borrowing is widely and usefully done by individuals and businesses and so too by countries. Trade deficits in the 1990s were a means to help finance an elevated level of domestic investment and may be so again if the current economic expansion gains momentum. Investment augments the nation's future productive possibilities and is a boon to long-term economic welfare.

Of course borrowing carries a cost as the lender at least demands that interest be paid on the borrowings. This "debt service cost" is a burden the borrower must carry tomorrow for living beyond his means today. One's judgement about the desirability or undesirability of the trade deficit may hinge on the benefits gained from that added spending relative to the debt service burden that is also incurred. That decision may depend on how the foreign borrowing is used. If used to finance investment (that raises productive capacity), the economy's future output may increase by an amount sufficient to meet debt service costs and also add to the output

[23]One might take note, that when trade is tallied across exchanges in goods *and assets*, trade is always balanced. A deficit in goods trade will be balanced by a surplus in asset trade and a surplus in goods trade is balanced by a deficit in asset trade.

available for domestic uses. If used to finance public or private consumption, there will be no enhancement of productive capacity, and meeting future debt service costs must come at the expense of future living standards.[24]

The United States net accumulation of foreign obligations is now in excess of $2 trillion and growing.[25] The current debt service burden of Americas stock of foreign debt can be roughly judged from the net investment income component of the current account balance. From a surplus of near $33 billion in 1981, U.S. net foreign investment income has fallen steadily to a deficit in 2002 of $5.4 billion.[26] A payment of this magnitude is very modest given the size of U.S. obligations and certainly does not suggest insolvency, but this payment could easily grow to $100 billion or more in the near future, and a net outflow of resources to foreigners of that size would be a significant decrement to the annual rate of advance of the nation's living standard and a decrement that can get larger. Some observers maintain that it is a burden that needs to be curtailed.

Another possible cost of large persistent trade deficits is that they are very likely to lead to more calls for costly protection from foreign competition. Economic analysis indicates that since such measures have no effect on the macroeconomic factors that cause a trade deficit, they will not reduce it.

Reducing the Trade Deficit

Reducing the trade deficit by policy actions is very problematic, however. Economic theory is clear that standard trade policy tools such as tariffs, quotas, and subsidies will not change saving or investment behavior and, therefore, will not reduce the trade deficit, but these devices will create economic distortions that reduce national economic welfare. Macroeconomic policy can affect the saving-investment balance and can change the trade deficit, but how to do so without harming domestic investment remains unclear. Generating a sustained increase in the economy's rate of saving by reversing the steadily sagging rate of household saving would reduce the trade deficit, but how to raise that rate is uncertain.

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[24]Whether used for investment or consumption, such borrowing and lending between nations is *intertemporal trade.* These are exchanges of current goods for claims on future goods and can also be seen as a type of gain from trade. If there are differences in the valuation of current versus future consumption between countries then gains from trade are possible The borrower gains by being able to consume now beyond what his current income allows. The lender gains by being able to consume more in some future period. International capital flows are thus facilitating a more efficient use of global saving and a more optimal pattern of spending over time.

[25]U.S. Department of Commerce, *Suvey ofCurrent Business,(*Bureau of Economic Analysis, July,2003).

[26]Two common indictments of the trade deficit — deindustrialization and net job loss — are not macroeconomic issues.. For a discussion of deindustrialization see CRS Report 98-440E, *Is Globalization De-Industrializing the U.S. Economy?: An Analysis*, by Craig K.Elwell.

There is also some prospect that the trade deficit may correct itself without any inducement by economic policy. There are good reasons to expect that normal economic forces will work to sate the demand for foreign borrowing as well as reduce the supply of foreign funds being offered. The combination of a moderate slowing of the pace of economic growth in the U.S.(reducing domestic investment relative to domestic saving at home) and a significant acceleration of the rate of growth abroad (raising domestic investment relative to domestic saving abroad) would likely initiate such a process. A change in relative growth rates away from the current differential would most likely alter rates of return between the United States and the rest of the world, redirect a larger share of international investment flows towards destinations other than the United States, and shrink the U.S. trade deficit At this time, however, it seems more likely that the U.S. will out perform the rest of the world .

Regardless of the relative pace of economic growth, foreign investors can step back from the purchase of more dollar assets in response to greater rates of return outside of the United States, or in an attempt to increase the diversification of their portfolios, now overly stocked with dollar assets. Such a move would decrease capital inflows to the U.S. market, and reduce saving available to the United States. The trade deficit, with a time lag, would tend to fall. But lacking an increase in the rate of domestic saving, interest rates would rise, and the rate of domestic investment would also fall.

The current depreciation of the dollar exchange rate may in part reflect some movement away from dollar assets by foreign investors. As was suggested above, it is difficult to predict if this will be a strong enduring trend. The dollar depreciation that has occurred so far is expected to at least slow the rate of increase of the trade deficit.

Conclusion

For economists the case for free trade is strong and compelling. A reduction of impediments to the flow of goods among nations will raise each trading nation's economic welfare. This conclusion has been repeatedly validated by studies of trade liberalization policies such as the Uruguay Round Agreement and NAFTA.[27]

However, public debate over such initiatives makes very clear that many Americans do not share economists' optimism about the virtues of free trade. Some of this antipathy might arise from economic concerns that U.S. workers and industries hurt by trade do not receive equitable compensation and other adjustment assistance. Allaying this concern, some economists argue, is best achieved by efforts to augment and refine the various government programs that help to support and retrain workers displaced and hurt by market forces.

Others may simply doubt that trade is beneficial. If unconvinced by the various technical studies, they might consider that the United States *itself* gives clear evidence of the virtue of free trade. This country is comprised of 50 separate political entities that under the Constitution are required to allow unfettered trade among themselves. Specialization has occurred, interstate trade has grown, and national economic welfare has benefitted[28]. Certainly U.S. economic welfare would be reduced if barriers to interstate trade were erected. Economists view the benefits of interstate trade as of the same nature as the benefit of international trade. In policy deliberations, of course, national economic welfare will be considered in conjunction with political, social, and national defense issues that will also influence trade policy.

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[27]For example see CRS Report 95-529 E, *The Uruguay Round: A Macroeconomic Assessment,* by Craig Elwell and Alfred Reifman; and, Nora Lustig, Barry Bosworth, and Robert Lawrence. *Assessing the Impact of North American Free Trade, (Washington, Brookings Institution, 1992.)*

[28]The fifty states, of course, have the same labor and environmental standards.