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Economics 101: Tariffs and Trade—Part 2; Deficits, China and More

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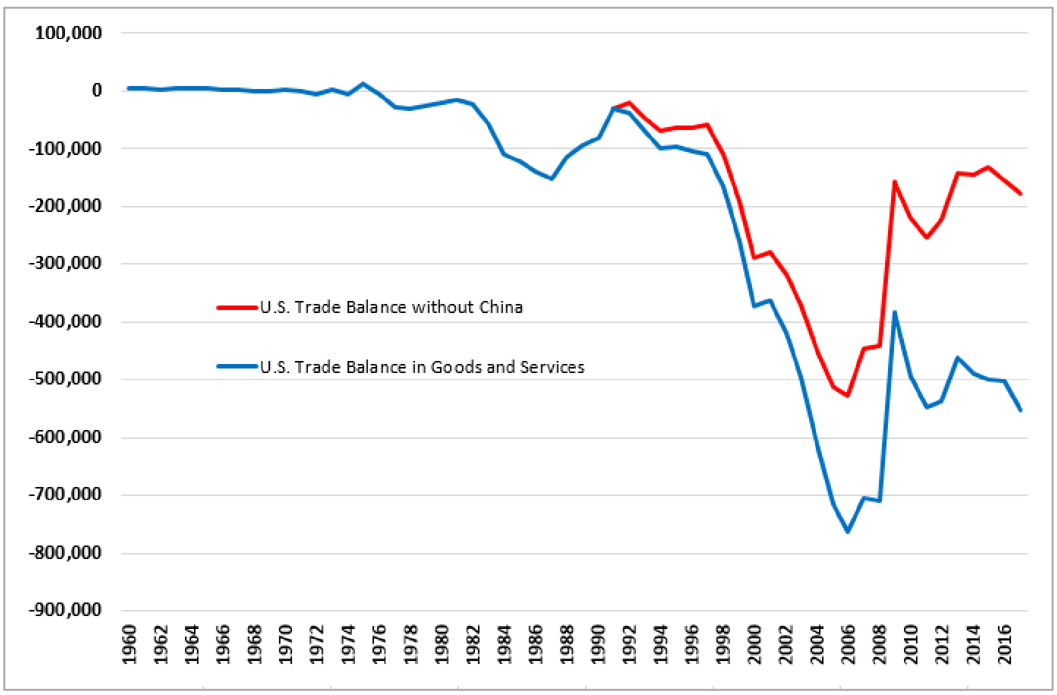
In our first ***Hibbs Brief*** on tariffs and trade, we noted that trade imbalances with a specific trading nation are the natural result of specialization. We wrote that one should not expect annual trading accounts in goods and services to balance between two given countries at the end of each year.[1] There are deficits with some countries, surpluses with others—and different results by nation in different years. However, we expect general balance between our exports and imports across all accounts with all other countries combined, and that's been our past history.

We emphasize: that's the way it used to be. In **Chart 1**, below, you can easily see that the U.S. balance of trade in goods and services with all other countries (combined) has not balanced in a very long time. We have run a trade deficit since 1976. While there were surplus years as well as deficit years from 1960 through the mid-1970s, our goods and services trade (or current account) deficits have become a permanent fixture. Further, the U.S. trade deficit really began to worsen after 2000.

Chart 1. U.S. Trade Balance, Goods and Services; 1960-2017 (in millions of dollars)



Note: Trade Balance with China includes goods only; services were not available.
Source: U.S. Census, Bureau; *Economic Indicator Division* and *USA Trade Online*.

[1] Goods include everything from plastic beach toys, appliances, and wearing apparel to auto parts, steel and electronic goods. This is where the very large deficit occurs. In the services side of the "goods and services sector" we often run a small surplus each year. Services are dominated by things like financial services, engineering design and software.

What happened?

The U.S. and several other countries worked to make trade freer after World War II. The first General Agreements on Tariffs and Trade (GATT), created in 1948, focused on reducing tariffs and increasing world commerce. Those older GATT agreements gave way to the development of both NAFTA, signed in 1994, and the World Trade Organization (WTO), begun in 1995. In Europe, a monetary union was begun in 1999 and brought into full force with the European Union in 2002. China joined the WTO in 2001 and began to contribute to world trade in a big way.[2] China even changed its national economic plan and business development effort to focus on becoming primarily a producer for international markets.

The idea of free trade had taken hold across the world. These trading zones and trade agreements were an outgrowth of this newly accepted idea—a correct one, we might add—that the world is a richer place with free trade that results in lower resource costs, greatly expanded output and lower prices.

Now, look again at Chart 1. Notice how U.S. trade deficits (imports exceeding exports) increased dramatically, to -$764 billion in 2006. Clearly, the new agreements/organizations gave rise to a persistent U.S. trade deficit, and just as clearly, China added substantially to that existing U.S. trade deficit problem. The continuing (lower) portion of the blue line shows the actual U.S. trade deficit with all countries. The line in red shows what our trade deficit would have been without including our deficit with China.

The U.S. sees its persistent deficits—more imports than exports—as a problem. Some suggest the "rust belt" is rusty because of free trade. They are only partly correct. Firms in all countries have to adjust to new competition. The U.S. has had to shift to producing more agricultural products on larger, more efficient farms and providing more specialized services. Those services include such things as engineering designs, environmental systems, software design, and new financial, insurance, accounting, and management services.[3] We note that tens of thousands of manufacturing jobs have been added by foreign firms opening plants in the U.S. – Toyota in San Antonio, BMW and Volvo in South Carolina, and Mercedes-Benz in Alabama are examples.

Manufacturing, we should add, is still alive and well in the U.S., but only in new plants incorporating competitive technology. Many economists argue persuasively that the lost mid-west manufacturing jobs were lost to places like Alabama and Texas, besides foreign locations. And, they were lost to new computerized, robotic technology.[4]

There are always real costs associated with free trade. Economists can show, however, that these dislocation costs are much lower in dollar amount than the value of the increased in goods and services produced. We cannot say, though, whether the short-run pain of those dislocations is too high and needs to be addressed.

Returning to the elephant in the room—China—there are other reasons why the U.S. might be upset with China as a trading partner, and most of these center on the way in which China trades, not the actual existence of free trade. One of these reasons is the rampant violation of U.S. intellectual property rights, with some designs taken by Chinese firms and the lack of enforcement by the government there. Another reason is the Chinese government's apparent manipulation of their currency from time to time that makes U.S. goods more expensive and less attractive, thus contributing to our lack of exports to China.

On the other hand, we need to note one major positive. Over the past 20-30 years, the Chinese have not sat on their large annual surplus of dollars. They have invested hundreds of billions annually in U.S. government financial instruments, which has helped keep U.S. interest rates low. Lower interest rates help U.S. families borrow to buy new homes and other goods. Lower interest rates also help the U.S. government fund its growing national debt at a much lower annual interest cost, too. And, that benefit is no small thing.

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[2] China has been a member of WTO since 11 December 2001. https://www.wto.org/english/thewto_e/countries_e/china_e.htm

[3] Educators, somewhat ineffectively, have been screaming for a full generation that students need more education, most of it centered in the STEM fields, because our future workers likely will not compete well in the world of making things by hand.

[4] International trade has certainly accelerated the relocation of factories, and many (if not most) new manufacturing plants require many fewer workers to produce the same output. One of the authors visited an auto plant in Asan, South Korea. Less than 100 workers were actually employed on the plant floor that was producing one car per minute out the door. There were several thousand employees nearby working in production management, computer IT, accounting, finance and marketing.