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The Uselessness of Trade Deficits in Calculating Economic Vitality

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Balance of trade is a useless measure of economic vitality. Trade deficits are not a measure of lost income or jobs; trade surpluses are not necessarily good things nor signs that a nation is "winning" a competition.

In the international balance of payments for the U.S., foreign investment is counted in the capital/financial account, while the balance of trade is on the other side of the ledger in the current account. The rules of accounting require that any deficit in one account be offset by a surplus in the other. That is, a net inflow of foreign investment creates a surplus in the capital/financial account that will necessarily be accompanied by a deficit in the current account (primarily the balance of trade in goods and services). Although this accounting identity may seem no more than an arbitrary bookkeeping rule, it makes economic sense.

Foreign Investment and Trade Deficits

Consider one particular Volkswagen manufacturing plant in the U.S. In 2009, Volkswagen started construction of its assembly plant in Chattanooga, Tennessee. When auto production started in 2011, the company had spent about $1 billion on the plant.[1] The plant employs 3,500 people directly and supports 22,000 additional jobs at nearby suppliers.[2] But the logic of "trade balance" asserts that if the factory had been built on barges and floated out to Germany, it would have counted as an export and have reduced the U.S. trade deficit, making the trade balance "better." Keeping the factory and its jobs in the U.S. increases the trade deficit, making the trade balance "worse." However, asserting that greater productive capacity in the U.S. worsens anything is nonsensical.

What happens in the hypothetical case of exporting the factory on barges? First, before Volkswagen can finance the project, it needs to sell $1 billion of German goods to Americans in order to finance the factory's construction.[3] The net effect is that Americans export a $1 billion factory in exchange for $1 billion of German products. The trade nets out and there is no impact on the trade deficit.

In the actual case, the factory stays in Chattanooga, while the ownership is transferred to a German company. Still, Volkswagen had to sell $1 billion of German goods to Americans to get the money to buy and build the factory. That $1 billion of German goods counts as imports to America and would increase the U.S. trade deficit by $1 billion. The inflow of the $1 billion Volkswagen spent in the U.S. to pay for the factory does not register in the balance of trade; instead, it registers on the other side of the balance of payments in the financial account. This inflow adds $1 billion to the financial account surplus.

In the hypothetical case, then, the trade deficit is unaffected; in the actual case, the trade deficit increases by $1 billion. However, this increase in the trade deficit neither increases America's poverty nor reduces its employment. In all likelihood, having the factory in Chattanooga increases both employment

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and income compared to the hypothetical case of exporting the factory.

The trade deficit created by Volkswagen's investment in Chattanooga is in no sense an indication of lost income, lost jobs, or a poorly negotiated deal. The factory in Chattanooga adds jobs, increases income, and shows Volkswagen betting on the American economy.

Purchasing Assets Instead of Building Factories

The story changes a little if foreign investment takes the form of buying existing assets instead of building a new factory, but it still does not eliminate jobs or reduce U.S. income.

To illustrate, the Abu Dhabi Investment Council purchased the Chrysler Building from an investment fund managed by Prudential Financial in 2008 for $800 million. As in the case of the Volkswagen factory, the $800 million would initially have had to come from selling $800 million of products and services to Americans. Stopping the story at this point would indicate that Americans traded an asset for consumption goods (e.g., petroleum from Abu Dhabi). However, whether the Abu Dhabi purchase leads to increased consumption or increased investment depends on what the Prudential fund and its investors did with their $800 million, not on whether Abu Dhabi sold investment goods or consumption goods to U.S. customers, nor on whether the Prudential fund investors sold to foreigners or Americans.

If the entire $800 million were distributed to the fund's owners and they all bought consumption goods, then that is the story—an asset sold to pay for consumption. However, if some portion were invested in a new plant, equipment, or other productive capital, then the story is more like the case of the new Volkswagen factory—the inflow of investment made the U.S. more productive.[4]

To the extent that the inflow of the $800 million ends up financing consumption, the asset-for-consumption is the story. However, this is not a story of trade deficits leading to reduced American-owned capital. It is a story of Americans deciding to invest less and consume more—which would have been the case even if the building had been sold to American investors. In any event, the fear that trade deficits are a sign that the U.S. is becoming a wino-country—selling the nation's productive wealth for immediate consumer gratification—is not born out by the data.

Between 2007 and 2017 the net wealth of the U.S. increased by more than $30 trillion.[5] Over that same period the total trade deficit was $5 trillion.[6] These numbers do not show that trade is leading the U.S. to eat its seed corn, but they are consistent with the centuries-old narrative that trade improves efficiency and expands the economy.

From 2007 and 2017, each year saw large trade deficits alongside correspondingly large financial account surpluses. The assertion that the U.S. was consuming its capital by trading assets for consumption simply does not fit the data. Over the same period, U.S. household net worth grew from $66 trillion to $97 trillion.[7] This growth in net worth was five times the total trade deficit for the same decade. Cap-

1. Mike Pare, "VW CEO: Volkswagen Delivered on New Chattanooga Plant," *Chattanooga Times Free Press*, May 25, 2011, http://www.timesfreepress.com/news/news/story/2011/may/25/vw-ceo-volkswagen-delivered-new-chattanooga-plant/50488/ (accessed June 22,2018).
2. Mike Pare, "VW to Invest $340 million in New 5-seat, Chattanooga-built SUV," *Chattanooga Times Free Press*, March 19, 2018, http://www.timesfreepress.com/news/breakingnews/story/2018/mar/19/vw-invest-340-million/466285/ (accessed June 22, 2018).
3. Of course, Volkswagen instead could sell $1 billion of German products to non-American holders of dollars, but this simply adds a complicating link in a chain that ends at the same place. Americans buy $1 billion worth of goods from foreign sellers who then buy the German products from Volkswagen. Volkswagen then uses the dollars to pay for the factory in Tennessee.
4. The story can be complicated, but the ultimate result is the same. It is likely that much of the $800 million was used by Prudential and the fund's owners to buy other existing assets. That just adds an additional step, with the question being what the sellers of those assets did with the money. Eventually the chain of asset sales will end with either new consumption goods or new investment goods.
5. Board of Governors of the Federal Reserve System, "Financial Accounts of the United States, Household Net Worth and Growth of Nonfinancial Debt Data, 2007 to 2017 Q3," December 7, 2017, https://www.federalreserve.gov/releases/z1/current/html/introductory_text.htm (accessed June 22, 2018).
6. U.S. Department of Commerce, Bureau of Economic Analysis, "U.S. International Transactions—Expanded Detail Data Set, 2007 to 2017," June 20, 2018, https://www.bea.gov/international/bp_web/tb_download_type_modern.cfm?list=1&RowID=2 (accessed June 22, 2018)
7. Board of Governors of the Federal Reserve System, "Financial Accounts of the United States, Household Net Worth and Growth of Nonfinancial Debt Data, 2007 to 2017 Q3."

ital flowing into the U.S. makes the nation more productive and richer even after the foreign investors take their share of the investment returns.

Foreign Finance of U.S. Federal Budget Deficits

Much of the inflow of capital goes to government bonds and notes. The federal debt held by foreign and international investors rose sixfold from 2000 to 2014, although it has held roughly constant since then at about $6 trillion.[8] Nevertheless, that is still nearly one-third of the outstanding federal debt.[9] Since federal borrowing mostly pays for consumption and not investment, it might seem that foreign finance of budget deficits *is* the equivalent of eating one's seed corn—trading away an asset that would provide larger future consumption in exchange for smaller consumption right now.

Certainly, the size of the U.S. national debt *is* worrisome and *does* represent trading away larger future consumption for less consumption right now. However, financing the debt with foreign capital rather than American capital does not make Americans poorer. Every billion dollars of federal borrowing absorbs a billion dollars that could (and for the most part would) have been invested productively. When American capital is used to finance the federal debt, productive investment is reduced by a like amount. When foreign capital finances the federal debt, it frees that American capital to be invested productively at home.

The size of federal borrowing matters, but that borrowing is driven by domestic spending and taxing decisions, not by the level of imports and exports. The inflow of foreign capital, made possible and necessary by trade deficits, still adds to America's productive capacity—even to the extent that the foreign capital is used to buy government debt. Since the foreign purchases of government debt allows American capital to go to private investment, the foreign purchases of American government debt effectively, albeit indirectly, add to America's productive capital—creating jobs and increasing income.

Conclusion

The definitions of "deficit" have negative connotations.[10] Using those definitions, a trade deficit implies that exports are too small. This is a misconception. The balance of trade compares the international flow of value in only one part of the balance of payments. Assigning the flows of money to various categories is arbitrary. Focusing on one arbitrary component (in this case the balance of trade) says nothing about the overall benefits of international trade and investment.

Trade always involves a two-way, balanced exchange. However, the balance does not always (or even usually) come in the form of matched flows of goods and/or services. A trade deficit means that the home country receives goods and services with a greater total value than the value of the home country's exports. However, this trade deficit is matched by an identically sized surplus in inflow of foreign investment into the home country.

The inflow of foreign investment to the U.S. promotes economic vitality at least as much as an equal flow of dollars for American goods and services. That is, a trade deficit neither eliminates jobs nor weakens the economy. A trade deficit should not be viewed as the result (or cause) of lost income or competition. Therefore, balance of trade as the goal of trade policy is a nonsensical proposition. Such a goal is more likely to hurt the economy than to help it.

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8. Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, "Federal Debt Held by Foreign and International Investors, 2000 to 2017," https://fred.stlouisfed.org/series/FDHBFIN (accessed June 22, 2018).
9. Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, "Federal Debt: Total Public Debt," https://fred.stlouisfed.org/series/GFDEBTN (accessed June 22, 2018).
10. Dictionary.com, "Deficit," http://www.dictionary.com/browse/deficit (accessed June 22, 2018).