America’s chronic trade deficit continues to set new records, both for its sheer size in nominal terms and for its share of an expanding gross national product. The record deficit is fueling worry that it could hurt U.S. industry, destroy jobs, burden future generations, and cause the current economic expansion to end in a “hard landing.” But those worries rest on a fundamental misunderstanding of the causes and consequences of the U.S. trade deficit.

In November 2000 the congressionally appointed Trade Deficit Review Commission issued its final report, *The U.S. Trade Deficit: Causes, Consequences and Recommendations for Action*. The report reflected the views of a sharply divided commission, with Democratic-appointed members warning of the dangers of the deficit while Republican-appointed members emphasized its more benign nature.

Economic theory and experience demonstrate that trade deficits are driven primarily by macroeconomic factors, in particular investment flows, and not by allegedly unfair trade barriers or declining industrial competitiveness.

Because of the link between trade deficits and rising investment, larger trade deficits are typically accompanied by improving economic conditions. A survey of the U.S. economy since 1973 confirms that, by almost any measure—economic growth, employment, industrial production, poverty reduction—the economy has performed better in years in which the trade deficit rose than in years in which it shrank.

America’s annual trade deficits are sustainable as long as the United States remains a safe and profitable destination for the world’s savings. The accumulating net foreign ownership of U.S. assets, America’s so-called foreign debt, does not threaten our sovereignty, our ability to finance that investment, or continued economic expansion.

The best policy response for the new administration and Congress would be to ignore the U.S. trade deficit as a target of policy and concentrate instead on maintaining a strong and open domestic economy that welcomes foreign investment.

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Introduction

America’s chronic trade deficit continues to set new records, month after month, year after year, not only for its sheer size in nominal dollars but for its share of an expanding gross domestic product. The large and growing gap between how much we import and how much we export continues to fuel anxiety among policymakers, economic commentators, and critics of American trade policy. But those worries rest on a fundamental misunderstanding of the causes and consequences of the U.S. trade deficit.

There is no dispute that the U.S. trade deficit has reached record territory. Although the United States has run a trade deficit every year since 1975, those deficits have reached an unprecedented level as the expansion of the 1990s stretches into a new decade. If current trade trends continue, the United States will run a deficit on goods and services of more than $360 billion in the year 2000. That’s up a third from the record deficit of $264 billion in 1999, and more than double the deficit of 1998. As a share of GDP, in 2000 the trade deficit will probably set a record of 3.6 percent, topping the previous record set in 1987 (Figure 1).

Trade skeptics, a majority of Americans, and a surprising number of trade journalists believe that a trade deficit of such magnitude can be only bad news. They assume that the trade deficit imposes a drag on growth and a net loss of jobs, because of either lost export opportunities or rising imports that displace domestic production. During the debate in 2000 over granting permanent normal trade relations (PNTR) to China, for example, opponents claimed that the deal would expand America’s bilateral trade deficit with China and cost as many as 1 million jobs in the U.S. economy during the next decade.

Immediate worries about the trade deficit have been compounded by more long-term concerns that the deficit is “unsustainable.” Critics of the trade deficit warn that chronic and growing deficits will burden future generations with a crushing “foreign debt,” leave America vulnerable to foreign pressure, and undermine foreign investor confidence in the United States, triggering capital flight, a downward spiral of the dollar, and a “hard landing” for the economy.

In 1998 those and other concerns prompted Congress to appropriate $2 million to establish and fund the Trade Deficit Review Commission with a mandate “to study the nature, causes, and consequences of the United States merchandise trade and current account deficits.” The 12-member panel of private citizens, half appointed by the Democratic leadership and half by the Republican leadership in Congress, heard testimony in Washington and around the country from economic experts, business and labor leaders, and other witnesses on the alleged causes and consequences of the deficit. The commission issued its final report on November 14, 2000.

The Trade Deficit Review Commission’s report was really two starkly contrasting documents be-
neath one cover—one authored by the Republican-appointed members, the other by the Democratic-appointed members of the commission. The Democratic side concluded that the trade deficit poses a threat to the U.S. economy, both immediately and in the long run. The Republican side, while agreeing that large and growing deficits cannot continue indefinitely, concluded that the deficit reflects more benign developments in the U.S. economy such as relatively strong growth and rising levels of investment.

How policymakers view the deficit will have important implications for U.S. trade policy. If they accept the view that the deficit poses a real danger to the U.S. economy, they will be more inclined to impose new trade barriers in an effort to curb imports, and less inclined to support new trade agreements that would open markets both at home and abroad. If they accept the view that the deficit is not a real danger, they will be more inclined to pursue further reductions in trade barriers to stimulate global trade.

The new Congress and administration will face political pressure to do something to “fix” the trade deficit. Although the trade deficit was not a major issue during the fall campaign, both the Republican and the Democratic parties cited it as a problem in their 2000 campaign platforms. With power in Congress almost evenly divided between the two parties, the trade deficit could be a major part of the trade policy debate. As an article in CQ Weekly concluded, “The next president may need to address this trade deficit with the same urgency that compelled his predecessors to tackle the budget deficit.”

Widespread misunderstanding about America’s trade deficit tilts the political playing field against further trade liberalization and toward harmful fixes that could include erecting barriers to imports. If new regional or multilateral trade agreements are negotiated during the 107th Congress, opponents of expanding trade will likely raise the same charges they have in the past about the impact of bilateral deficits and the overall deficit on jobs, industry, and the economy.

Back to Basics on the Trade Deficit

Evaluating claims about the consequences of the trade deficit requires an understanding of its causes. Not surprisingly, the two factions of the Trade Deficit Review Commission came to widely differing conclusions about the causes of the persistent U.S. trade deficit. The Democratic-appointed members contended that the deficit is caused primarily by high trade barriers abroad, predatory import pricing, declining competitiveness of core U.S. industries, and low wages and poor working conditions in less-developed countries. The Republican-appointed members explained the deficit as the result of macroeconomic factors in the U.S. economy—specifically levels of national savings, investment, and economic growth—and exchange rate movements.

Economic theory and experience weigh heavily in favor of the explanation that trade deficits are driven primarily by macroeconomic factors, in particular investment flows, and not by allegedly unfair trade barriers or declining industrial competitiveness. Nations that are net recipients of foreign investment will run current account deficits, while nations that are net investors in the rest of the world will run surpluses. (The current account is the broadest measure of international trade, including goods, services, income from international investments, and unilateral transfers such as foreign aid and private remittances. The trade deficit includes only trade in goods and services. For the United States, the two figures are currently about equal in magnitude, and for purposes of this discussion the terms will be used interchangeably.)

The underlying cause of the U.S. trade deficit is the fact that domestic savings in the United States is insufficient to fund all the available domestic investment opportunities. Any savings gap is filled by a net inflow of foreign investment. Those foreign funds allow Americans to buy more than we sell in the international market for goods and services, resulting in a trade deficit. As long as the pool
of domestic savings available for investment is smaller than the actual level of investment, the United States will run a trade deficit. Conversely, if the pool of domestic savings exceeds domestic investment, the extra savings will flow abroad, resulting in a trade surplus.4

The relationship between the current account and the capital account can be explained by the simple expression:

Net exports = Savings - Investment

That identity helps to explain changes in national trade balances. A change in net exports can be explained by a change either in national savings or in the level of investment, or both. For example, if the level of national savings falls—say because of an expanding government budget deficit—then, all else being equal, net exports will fall (that is, an existing trade deficit will expand). The same result will occur if, all else being equal, investment rises. In both cases, more capital must be attracted from abroad to fill the expanding gap between savings and investment. If investment falls while national savings remains fixed, then net exports will rise (that is, an existing trade deficit will shrink).

The fundamental reason the U.S. trade deficit has grown so rapidly in the past decade has been a dramatic increase in domestic investment.5

The causes of bilateral deficits with specific trading partners are more complex. Bilateral deficits can be driven by factors other than investment flows. Bilateral deficits can be determined by natural resource endowments (oil being a prominent example), differing growth rates and levels of development, consumer tastes, and, yes, trade barriers. But unless those factors affect the level of savings and investment in the United States they will not change America’s overall trade balance. Lowering foreign trade barriers through negotiation, or keeping or raising our own barriers to products from specific countries, will not put a dent in the overall U.S. trade deficit. As Catherine Mann of the Institute for International Economics writes:

To affect the overall [trade] balance, bilateral trade policy must work through the channels of savings and investment—for example, by changing business profitability or the household savings rate. Simply altering the level of exports into a particular market will do relatively little to change these savings rates; consequently, bilateral trade efforts generally will not significantly narrow the overall trade gap.6

If the United States managed, through changes in trade policy, to reduce its bilateral deficit with one trading partner, bilateral balances with other trading partners would simply adjust accordingly, leaving the overall trade deficit unchanged.

The very notion of “balanced trade” as a policy goal betrays a lack of understanding of the trade deficit and how it reflects underlying economic realities. A world of balanced trade
would be a strange place indeed. Every nation would save exactly what it needed to finance every economically profitable domestic investment, no more and no less. And every nation would have the same natural resources, level of development, consumer tastes, trade policy, and business cycle as its trading partners. That is not the world we live in.

**The Trade Deficit and Economic Performance**

Members of the Trade Deficit Review Commission were just as divided in their view of the consequences of the deficit. Republican-appointed members concluded that the trade deficit reflects economic strength, not weakness:

The trade and current account deficits are principally the outcomes of our strong growth, and clearly America is better off with strong economic growth. Furthermore, as many witnesses told the Commission, economies that are open to international trade generally have far better records of economic growth and better living standards than those that are less open.

Democratic-appointed members, in contrast, blamed the trade deficit for a number of economic ills they believe afflict the United States:

The costs of America’s decades of unbalanced trade with the rest of the world have been large and are manifest in a number of ways. These costs include job loss and increased economic insecurity for U.S. workers as well as downward pressure on the wages of U.S. workers and growing income inequality. Persistent trade deficits have also contributed to the erosion of the U.S. manufacturing base and the loss of long-run competitiveness.

The latter, dark assessment of the trade deficit’s impact on the economy is difficult to square with America’s economic performance during the past decade. Since 1992, while the trade deficit has grown dramatically larger, the U.S. economy has enjoyed a record-breaking expansion, the unemployment rate has fallen to a 30-year low, inflation has been down, productivity has been accelerating, manufacturing output has reached record levels, and real compensation and household incomes have been rising across all income levels.

In fact, growing trade deficits are typically accompanied by improving economic conditions. The explanation lies in the link between the deficit and the level of savings and investment. If a nation’s rate of savings rises or if investment falls (as it usually does during a recession), its trade deficit will shrink. Conversely, if savings fall or investment rises (as typically happens during an expansion), the trade deficit will grow. For this reason, trade deficits tend to be pro-cyclical: They rise and fall along with the growth rate of the economy. When growth accelerates, the trade deficit tends to grow. When growth slows, or turns negative, the trade deficit tends to contract, sometimes sharply.

As evidence, consider the relationship between America’s economic performance and the current account deficit since 1973. As Figure 2 indicates, the current account typically moves in the direction of surplus during

**Figure 2**

**America’s Current Account Deficits, 1974–2000**

![Graph showing the relationship between America’s economic performance and the current account deficit since 1973.](image)

recessions and in the negative (or deficit) direction in the midst of economic expansions.

A survey of the U.S. economy since 1973, when the era of floating exchange rates and free capital flows began, only confirms that rising trade deficits generally accompany periods of rising investment and expansion for the U.S. economy. Since 1973 America's current account deficit as a percentage of GDP has grown larger—or, in the parlance of the typical news report, “worsened”—in 16 years and shrunk—or “improved”—in 11. By almost any measure, the America economy has performed better in years in which the trade deficit rose compared to years in which it shrank. (See Table 1 and Appendix.)

**GDP Growth**

During years of rising deficits, the growth of real GDP averaged 3.5 percent per year, compared to 2.6 percent during years of shrinking deficits. In other words, our economy typically grows more than one-third faster in years in which the trade deficit expands than in years in which it shrinks. The causation, of course, flows from growth to the trade deficit: In a more rapidly growing economy, demand for investment capital and for imports will both increase. Rising incomes stoke demand for imports, and an inflow of foreign capital provides the means to help pay for them.
Employment
The story of jobs is much the same. During years of “worsening” trade deficits, the unemployment rate has, on average, fallen by 0.4 percentage points. During years of “improving” deficits, the unemployment rate has, on average, risen by 0.4 percentage points. Again, this is not to say that a rising trade deficit causes unemployment to fall. Causation works in the other direction: expanding payrolls boost total domestic income, which in turn raises demand for imports. Once again, the protectionists have it wrong: imports do not destroy jobs; job creation fuels demand for imports.

Manufacturing
Critics of the trade deficit argue that it is causing the “deindustrialization” of America. While our economy may be producing service jobs, we are supposedly shipping our manufacturing capacity overseas. Again, the evidence of the past three decades points in the opposite direction. During years of rising current account deficits, manufacturing output in the United States grew an average of 4.6 percent a year (December to December). During years of shrinking deficits, the average growth rate of manufacturing output was a much less robust 1.0 percent—less than one-quarter the rate of growth during years of rising deficits. The automobile industry—long a symbol of American industrial might—saw domestic output of cars and light trucks rise an average of half a million units during years of rising deficits, and output typically fell by 600,000 units in years when the deficit shrank.

Employment in the manufacturing sector grew slightly, on average, in years in which the trade deficit “worsened,” and a net total of more than 100,000 manufacturing jobs was eliminated, on average, in years when the trade deficit “improved.”

Poverty
Americans on the margins of poverty also appear to fare somewhat better when the trade deficit expands. In years when the deficit grew, the poverty rate in America fell an average of 0.2 percentage points from the year before. In years when the deficit shrank, the poverty rate rose by an average of 0.3 points. The same expanding economy that causes the trade deficit to grow also lifts a larger share of Americans out of official poverty.

The contention that trade deficits somehow damage the U.S. economy is directly challenged by the superior performance of the U.S. economy during times of rising trade deficits. If trade deficits drag down growth, destroy jobs, decimate manufacturing, and hurt the poor, then why are bigger deficits associated with faster growth, a falling unemployment rate, accelerating industrial output, and fewer people living in poverty?

Trade Deficits and Jobs:
China as a Case Study
One of the most frequent charges against the trade deficit is that it eliminates jobs. Critics reason that if, as claimed by trade advocates, every $1 billion in exports creates a certain number of jobs, then every $1 billion in imports must destroy a certain number of jobs by displacing domestic production. And thus, if our nation is running a large trade deficit, more jobs will be destroyed than created.

What this argument fails to consider is that the number of jobs in an economy is determined not by the level of trade or technology but by broader economic conditions such as monetary policy, growth rates, and labor market regulations. Trade does not determine the number of jobs but rather the type and quality of jobs. Trade raises the overall productivity of the workforce by allowing capital and labor to shift toward sectors where Americans are relatively more productive. Like technology, it does cause certain industries to decline, thus eliminating some jobs, but it also creates new opportunities for wealth and job creation. In an economy with reasonably efficient labor markets, jobs eliminated by technology and trade will be fully offset by the creation of new jobs.

A blatant example of overblown rhetoric about the trade deficit and jobs comes from a May 23, 2000, segment of the NewsHour with
Jim Lehrer on PBS. In summing up why the House should reject PNTR with China in a vote the next day, AFL-CIO executive Richard Trumka asserted:

No one is saying isolate China. That’s the smoke screen they blow out because they don’t have the facts. Look, we have a $70 billion trade deficit with China. The U.S. International Trade Commission came out with a study yesterday [Monday, May 22, 2000] saying, if you give them permanent NTR status, two things will happen: We’ll lose one million jobs, and the trade deficit will increase.¹¹

Trumka’s sweeping claim is a textbook example of how opponents of trade liberalization abuse trade deficit figures to serve their agenda. In fact, the U.S. International Trade Commission had issued no such study that week on trade with China. The USITC’s most recent study on the economic impact of PNTR with China had been released in August 1999, and it contained no estimate of job gains or losses.¹²

The actual source of the figure of 1 million jobs lost was a paper released the week before the vote on PNTR with China by the Economic Policy Institute, a union-aligned, nonprofit organization.¹³ The EPI extrapolated from numbers in the USITC study an estimate of future bilateral trade deficits with China. It then further crunched the hypothetical trade deficit numbers to estimate a total loss of almost 900,000 jobs during the next decade if Congress were to approve PNTR with China. But the EPI estimate of job losses was based on a series of flawed assumptions.

USITC Forecast Stretched beyond Recognition

The first serious error of the EPI study was to misapply the USITC’s estimates for growth in trade with China. The USITC study offered only a one-year, static estimate of the impact of Chinese tariff liberalization on the U.S. trade deficit. Because of the lack of data available at the time, the USITC was not able to quantify the full impact of a reduction in China’s considerable nontariff barriers. Furthermore, the USITC study did not even attempt to estimate the number of American jobs that would be created or eliminated by the further opening of the Chinese market.¹⁴

What the USITC study did predict was that tariff reductions of the magnitude China was offering at the time would cause U.S. exports to China to increase 10.1 percent and U.S. imports from China to increase 6.9 percent above what they would be without the liberalization. The growth in exports to China would be stimulated primarily by the lower tariffs, while imports from China would grow because “trade liberalization helps make China’s export sectors more competitive.”¹⁵ Although exports would grow faster than imports, the bilateral trade deficit would also grow because the smaller growth rate of imports would be applied to a much larger base.

The EPI study used the USITC numbers to extrapolate trade trends for a full decade into the future, assuming that China’s liberalization would cause a 10.1 percent increase in exports and a 6.9 percent increase in imports each and every year. On the basis of those assumptions, the EPI estimated a bilateral trade deficit with China of $106 billion by 2010, up from $59 billion in 1999.¹⁶ But the USITC study was an estimate of a one-time increase that would have occurred had China’s tariffs been lower, not a forecast of future annual growth rates.

In a letter to the president of the EPI, the USITC’s director of operations, Robert A. Rogowsky, explained a major flaw in the EPI’s methodology:

Here the basic misunderstanding of the USITC’s methodology is most clear. The USITC did not use a forecasting model; the estimates are not forecasts. They are estimates of the cumulative percentage changes in U.S. exports and imports from China had China joined the WTO in 1998. The numbers the EPI study uses as the base and multiplied by ten to get a decade’s worth of effect are estimates of the full
cumulative effect of China’s tariff offer, not year-to-year changes. To simply multiply sector variables by those estimates assumes that a new Chinese accession happens each year. This is unlikely. 17

In other words, the EPI forecast of the growth in the bilateral trade deficit was in no way based on the USITC trade model. Instead, it wrongly assumed that a point estimate of the effect of China’s one-time entry into the WTO would replicate itself year after year for a decade.

Imports Do Not Mean Lost Jobs
The EPI’s second crucial error was to assume that rising imports from China automatically mean lost jobs in the U.S. economy. According to the EPI’s methodology, the additional increase in U.S. exports to China that it predicts over the next decade will create an additional 276,221 jobs, while the additional increase in imports will eliminate 1,148,313 jobs. The net loss of jobs during the next decade because of PNTR would thus be 872,091 (which Trumka conveniently rounded off to “one million” and attributed not to the EPI but to the USITC).

Rising imports need not and typically do not translate into a net loss of jobs. In fact, the growth of real goods imports and manufacturing output tend to be positively correlated. That is, as manufacturing output rises in the United States so too do imports of goods, adjusted for price changes.

Figure 3 shows the strong connection between manufacturing output and imports. If the EPI analysis were correct, we would expect manufacturing output to decline as a rising volume of imported goods replaced domestic production. But since 1987 manufacturing output has generally expanded along with import volume, with output rising the fastest during years in which the growth of real goods imports also has grown the fastest. The same economic expansion that spurs manufacturing output also attracts more imports and enlarges the trade deficit.

Trade critics such as the EPI wrongly assume that every import from China displaces domestic production, eliminating jobs in the economy. In reality, much of what we import from China, such as toys, shoes, and clothing, substitutes for imports from other low-wage producers. Another sizable portion of our imports consists of intermediate inputs, which are then assembled into U.S.-made products by American manufacturers. That helps to explain why there is no correlation between rising manufacturing imports from China and falling manufacturing output.

The EPI analysis assumed that passage of PNTR with China would entice U.S. companies to relocate en masse to China—that “giant sucking sound” again, this time over the Pacific. But if U.S. companies gain greater access to the Chinese market through PNTR, they will be better able to export goods to China from U.S. plants rather than be forced to build plants in China to gain access. The EPI points to Mexico as an example of such capital flight, but in the five years after passage of the North American Free Trade Agreement, U.S. direct investments in Mexican manufacturing

Figure 3

Changes in trade policy have only a limited and indirect effect on a nation's overall trade balance.

Overall Trade Balance Unaffected

A third critical error of the EPI study was to consider the bilateral trade balance with China in isolation. For reasons explained above, changes in trade policy have only a limited and indirect effect on a nation's overall trade balance. While a change in trade policy can affect a particular bilateral deficit, the increased bilateral deficit tends to be offset by changes in other bilateral balances.

The USITC study confirms this. The USITC estimated that China's lower tariffs would cause America's overall trade deficit to shrink slightly. Although America's bilateral deficit with China would increase, according to the USITC's limited model, our trade balance with other countries would "improve" enough to more than offset the increased deficit with China. In the same table from which the EPI drew its growth numbers for the bilateral deficit with China, the USITC estimated that America's total exports would grow by $1.9 billion while imports would grow by $1.1 billion, decreasing the overall U.S. trade deficit by $0.8 billion. According to the EPI's own faulty methodology, the smaller overall U.S. trade deficit caused by China's lower tariffs should lead to an increase in U.S. jobs, not a decrease.

Although the debate about PNTR with China is over, the argument about trade deficits and jobs is sure to resurface. Whenever Congress considers a proposal to expand trade, opponents invariably argue that the trade deal will expand the trade deficit and that a larger deficit will mean lost jobs. The facts indicate otherwise. Rising imports do not depress overall domestic production or cause a net loss of jobs. In fact, America's recent economic experience demonstrates that growing imports and an expanding trade deficit are often signs of faster growth and rising employment.

The Long-Run Impact of the Trade Deficit

With the American economy performing so well during a time of record trade deficits, it has become increasingly difficult to argue that trade deficits have an immediate negative impact. As a consequence, concern about the trade deficit has shifted to the question of whether the deficit is "sustainable."

As was the case with the causes and immediate consequences of the trade deficit, the Trade Deficit Review Commission could not agree on the long-term consequences of the trade deficit. The Democratic-appointed members warned that chronically large trade deficits could undermine global confidence in the U.S. economy and U.S. leadership, precipitate a "hard landing" that would end the current expansion, and burden the economy with large payments to finance the growing stock of foreign investment in the United States.

GOP-appointed members agreed that the trade deficit, as a share of GDP, "cannot continue to increase without end" but must at some point reverse itself. Nonetheless, they concluded that "the fundamental strength and flexibility of the U.S. economy, the attractiveness of the United States as a destination for foreign investment, along with the ability of the U.S. economy and financial markets to adjust to changing circumstances, lead us to conclude that at some point in the future the trade deficits will most likely come down in an orderly way without significant disruption to the U.S. economy."

"Foreign Debt" in Perspective

One consequence of annual trade deficits is that foreign investors acquire more assets in the United States than Americans acquire abroad. The difference between the value of assets Americans own abroad and those foreign investors own in the United States is called the net international investment position of the United States. For most of the 20th century, America's net international investment position was positive, that is, Americans owned a...
larger stock of investment abroad than foreigners owned in the United States. But since the late 1980s, driven by a surge of foreign capital into the United States, the nation’s net international investment position has turned negative. By the end of 1999 the gap between the current market value of foreign-owned assets in the United States and that of American-owned assets abroad reached $1,473.7 billion, and it could soon approach $2 trillion.\(^{22}\)

This change in status is often described as an ominous transformation of America from the world’s largest “creditor nation” to the world’s largest “debtor nation.” But much of what foreigners have invested in the United States cannot accurately be described as imposing any kind of “debt” on American citizens. Almost half of the $8.65 trillion in foreign-owned assets in the United States at the end of 1999 was equity investment in U.S. real estate and corporations, with $2.80 trillion in the form of foreign direct investment and another $1.44 trillion in portfolio investment in corporate stock.\(^{23}\) (See Table 2.)

None of that equity investment represents debt in the sense of an obligation to repay a fixed amount over a certain time period. When a German firm acquires an American automobile or wireless telephone company, or when Japanese investors buy real estate in Hawaii, or when a British pension fund adds 100,000 shares of Microsoft to its portfolio, no American is under any legal obligation to repay anything. The foreign investor in U.S. equities will receive only what the market determines the asset is worth at the time of resale.

Moreover, the sheer size of America’s negative net international investment position is not alarming when compared to the overall size of the U.S. economy. At the end of 1999 America’s negative net international investment position of $1.47 trillion represented about 16 percent of that year’s GDP. In other words, Americans were producing enough every two months to buy back the difference between foreign-owned assets in the United States and U.S.-owned assets abroad. America’s “foreign debt” in 1999 was only about 4 percent of the net wealth of all U.S. households and nonprofit organizations.\(^{24}\)

A related worry about the net accumulation of foreign assets in the United States is our ability to make future payments to the owners of those assets. Like the federal government’s own accumulated fiscal debt, this issue arouses intergenerational concerns that we might be burdening our children with future obligations in order to support current consumption. But by any measure, America’s net payments on investment are modest and should be manageable for the foreseeable future. In 1999 Americans paid out $294.6 billion in dividends and interest to foreign investors and received $276.2 billion from U.S. investments abroad, for a net payments deficit of $18.4 billion.\(^{25}\)

Once again, what may seem to be a large amount in nominal terms proves to be modest when compared to America’s $9.3 trillion GDP in 1999. As a share of what we produce, the net investment payments flowing out of the United States in 1999 amounted to less than one-fifth of 1 percent of GDP. The equivalent net “debt service” payment for a family earning $75,000 a year would be $148.

If trends of the last decade continue, net payments to foreigners will continue to grow, both nominally and as a share of GDP, but not to a burdensome level. If payments on foreign-owned assets in the United States and receipts

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### Table 2

Foreign-Owned Assets in the United States (1999 year-end, billions of U.S. $)

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Value (billion U.S. $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct investment (at market value)</td>
<td>$2,801</td>
</tr>
<tr>
<td>Portfolio investment in corporate stock</td>
<td>1,446</td>
</tr>
<tr>
<td>Corporate and other bonds</td>
<td>1,064</td>
</tr>
<tr>
<td>Bank deposits</td>
<td>1,082</td>
</tr>
<tr>
<td>U.S. Treasury securities</td>
<td>661</td>
</tr>
<tr>
<td>Foreign official assets</td>
<td>869</td>
</tr>
<tr>
<td>U.S. liabilities to unaffiliated foreigners</td>
<td>474</td>
</tr>
<tr>
<td>U.S. currency</td>
<td>251</td>
</tr>
<tr>
<td><strong>Total foreign-owned assets in the U.S.</strong></td>
<td><strong>$8,648</strong></td>
</tr>
</tbody>
</table>

on U.S.-owned assets abroad were to continue to grow at the same annual rate as during the last decade, America’s net payments deficit would reach $207 billion by 2009. But if we assume a 5.5 percent annual growth of nominal GDP during that same period, net payments as a percentage of GDP would still amount to only 1.3 percent (Figure 4). For our hypothetical household, net service payments would rise to a still manageable $960 a year.

Meanwhile, the additional domestic investment made possible by the net inflow of foreign capital raises the underlying growth rate of the U.S. economy. Current and future workers will be more productive because of the larger capital stock, thus expanding the economy and easing the relative burden of servicing our net foreign investment position.

The alternative to the inflow of foreign capital, of course, is an outflow, or what is known under certain conditions as “capital flight.” Chronic outflows of capital can point to problems far more serious than persistent inflows. Russia, for example, has run a current account surplus every year since records became available in 1994, including a relatively large $25 billion surplus in 1999.26 Those surpluses are a sign not of economic strength but of economic weakness.

A Stake in America’s Prosperity

A second, persistent worry is that growing foreign ownership of U.S. assets will leave America vulnerable to foreign influence and manipulation. The fear is that America’s principal creditors, Japan in particular, could wield influence over U.S. government decisions by threatening to cut off the supply of capital inflows, or by threatening to withdraw capital already invested.

Foreign investors in theory could attempt to exert political pressure on the United States by threatening to curtail investment here, but such an act would have negative consequences for the investor as well as for the host country. Americans would lose, of course, because a withdrawal of capital would drive up domestic interest rates while the falling dollar would make imports more expensive, reducing the purchasing power of American workers. But America’s creditors would also suffer if their alternative investments were less profitable. Foreign investors would be further harmed if the U.S. economy were to tip into a recession. Falling demand in the United States would quickly translate into falling exports to the U.S. market, while a depreciating U.S. currency and slumping economy would depreciate the value of foreign-owned assets remaining in the United States.

The foreign-influence scenario also assumes that foreign investors would act in concert, but such an orchestrated withdrawal of credit seems unlikely. Private investors in industrialized countries do not usually act at the behest of their governments. Even in Japan, a government decision to dump dollars or withdraw funds from U.S. markets would not mean that private companies and individuals would necessarily do likewise. If the real U.S. economy remains fundamentally sound, other global investors would likely see the temporary decline in the dollar and U.S. asset prices as an opportunity to buy. The foreign governments attempting to exert “leverage”

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Figure 4
Balance of Payments on Foreign Investment Income


Note: Projections assume continuation of 1990–99 growth rates.
over the United States would in the end inflict only temporary damage on the U.S. economy at the cost of their own long-term interest.

When an economy is as large and as important to the global economy as is that of the United States, its chief “creditors” have a stake in keeping it healthy. They have a strong incentive to act prudently with their investments so as not to undermine their own positions. If any country wields leverage, it is the world’s chief “debtor,” the United States.

The “Hard-Landing” Scenario

A third looming worry about the trade deficit is that it will eventually undermine the confidence of foreign investors. According to this scenario, the rising trade deficit spooks foreign investors into withdrawing funds, starting a downward economic spiral. Typical is this dispatch from the Associated Press on September 21, 2000, the day the Commerce Department announced another record monthly trade deficit figure:

While the huge deficits have not yet had much impact on the overall economy, analysts are growing concerned that the shortfalls could become a problem if foreigners, who until now have been happy to accept U.S. dollars in payment for their products, change their minds. If they begin cashing in their dollar-denominated investments on Wall Street, the dollar and stock and bond markets could crash, the analysts say.27

Most international investors are savvy enough to understand that America’s trade deficit is a reflection of underlying strength, not weakness, for all the reasons outlined above. The U.S. trade deficit, by accommodating an inflow of foreign capital, actually encourages lower interest rates and thus promotes economic growth.

As for exchange rates, the trade deficit is not the cause of a weaker dollar but instead is associated with a stronger dollar. Since 1980 the trade deficit as a percentage of GDP has closely tracked the real value of the dollar on the foreign exchange market. When the dollar rises, so does the trade deficit, and vice versa (Figure 5). The real value of the U.S. dollar trended upward in the 1990s along with the size of the trade deficit.

A strong dollar and a rising trade deficit are not in conflict. While the trade deficit does increase the supply of dollars abroad, which by itself would put downward pressure on the dollar, the demand by foreign investors for dollars to buy U.S. assets has been even greater, resulting in a net appreciation of the dollar. As long as foreign demand for U.S. assets remains strong, the dollar will remain high, and so will the current account deficit.

Foreign investors could reach a point where they believed their portfolios had become overweighted with investments in the United States. But there is no reason to think that point has arrived, or will anytime soon. The United States remains the world’s largest economy, and among the freest and most dynamic. The amount of net foreign investment that flows into the United States each year is not out of proportion to the U.S. economy’s size in the global economy. In testimony before the Trade Deficit Review Commission, Harvard professor Richard Cooper offered this explanation:

How sustainable is the U.S. [trade] deficit? Put another way, how long are foreigners likely to be willing to invest $300 billion a year in the United States, net of U.S. investment abroad? Gross world savings outside the United States will exceed $5 trillion in 2000. $300 billion will be less than 6 percent of this magnitude. It is not beyond imagination that foreigners will want to invest 6 percent of their savings in the United States, which in 1998 accounted for over one-quarter of gross world product and whose stock market capitalization was nearly half the world’s total. . . . Investments in the United States have provided, and are likely to continue to provide,
returns that are both high and reliable compared with most other parts of the world.\footnote{28}

Persistent trade deficits can be sustainable for long periods of dynamic growth. The United States ran annual trade deficits with the rest of the world for most of the 19th century. America’s balance of trade in goods and services was negative in 50 of the 63 years between the 1830s and the 1890s, including every year but one during the more than a quarter century between 1848 and 1875.\footnote{29} In fact, America was a “debtor nation” for half a century, from the Civil War to the First World War.\footnote{30} The inflow of foreign investment that those deficits accommodated helped to build an infrastructure of canals and railroads during a period of rapid growth and rising living standards.

Australia, a country similar to the United States in its level of economic development, has run current account deficits every year since 1973. Those deficits have been larger than America’s as a percentage of GDP, averaging 4.6 percent since 1983 and reaching 5.7 percent in 1999.\footnote{31} By the end of 1999 Australia’s negative net international investment position (that is, its “foreign debt”) reached 57 percent of GDP,\footnote{32} more than three times the ratio in the United States. And like the United States, Australia is enjoying a long expansion fueled and prolonged in significant measure by a large annual net inflow of foreign investment.

Of course, any nation open to the global economy could in theory suffer an exodus of capital. If foreign investors decide to sell off assets, or if domestic investors do the same and send their money abroad, the currency will fall, upward pressure will build on interest rates, growth will slow, and the economy could suffer the proverbial hard landing. But such a scenario could occur whether a country was running a trade deficit or a surplus, whether its net international investment position was negative or positive. As long as capital is not held hostage to government controls, a loss of investor confidence could trigger capital flight and the economic ills that would come with it. That fact is an argument not for capital controls but for sound economic policies that encourage long-term, profitable investment.

Americans would be even better off in the long run if we saved more of what we produce, thereby reducing the amount of foreign capital needed to fund domestic investment. With a larger pool of domestic savings available, we could fund the investment needed to promote growth while at the same time retaining a larger share of the interest and dividends paid to the owners of the nation’s capital stock. But as long as domestic savings fall short of domestic investment, it is far better to welcome capital from abroad than to be forced to reduce investment to the level of domestic savings.

America’s annual trade deficits are sustainable as long as the United States remains a safe and profitable destination for the world’s savings. The accumulating net foreign ownership of U.S. assets does not threaten our sovereignty, our ability to finance that investment, or continued economic expansion.
A Few Policy Guidelines

Given the contrasting judgments about the causes, consequences, and sustainability of the trade deficit, it is not surprising that the commissioners divided sharply on their recommendations on what to do about it. While all members agreed on the desirability of lower trade barriers abroad, the Republican-appointed members specifically endorsed a new round of multilateral trade negotiations through the World Trade Organization. The Republican-appointed members also endorsed “increasing the extent to which domestic saving is adequate to finance domestic investment,” thus reducing the inward flow of foreign investment that drives the trade deficit. Democratic-appointed members presented a list of 30 recommendations focused primarily on promoting and protecting industry at home and enforcing tougher agreements against trade barriers abroad.

Although the commissioners spent much of their time debating trade policy, the very nature of the trade deficit argues against the use of trade policy as a means to reduce or eliminate it. The trade deficit is a function of macroeconomic levels of savings and investment in the economy, not differing levels of trade protection. Therefore, trade policy will be an ineffective instrument in any attempt to reduce the trade deficit.

If policymakers are convinced that the trade deficit must be reduced, they should avoid “solutions” that would do more harm than good. In a presentation at a recent Cato Institute Trade Policy Forum, Robert Lawrence of the Council of Economic Advisers recommended four guidelines that should be considered in any policy response to the trade deficit:

• It is better to reduce the current account deficit through faster growth abroad than through a recession or slow growth in the United States.
• It is better to reduce the trade deficit through increased domestic saving than through reduced domestic investment.
• It is better to complement the adjustment to a smaller trade deficit through opening foreign markets than through closing the market in the United States.
• It is better to encourage such adjustment, as much as possible, through faster foreign growth, a higher rate of domestic savings, and more open markets abroad than through a weakening in our currency.33

A domestic recession would reduce the trade deficit, as it has in the past, but at great cost to U.S. workers and their families. A far better approach would be to encourage faster growth abroad through the liberalization of trade and investment flows and the spread of technology. “We have a great interest in seeing this new economy and its new technologies diffused to the rest of the world,” Lawrence said.34

Domestic savings can be increased both by raising the savings rate in the private sector and by avoiding deficit spending in the public sector. Private savings could be stimulated by removing disincentives to savings in the tax code and by reforming entitlement programs to emphasize investment rather than pay-as-you-go income redistribution. A larger pool of domestic savings would bring down the trade deficit and reduce payments to foreign owners of capital without requiring a reduction in domestic investment.

Although trade policy does not directly alter the trade deficit, opening markets at home and abroad is a worthy objective in and of itself because it raises productivity and living standards. By spreading the benefits of free trade and economic integration, multilateral trade negotiations can encourage more robust growth in our trading partners, indirectly affecting the deficit.

Finally, a strong currency enhances the purchasing power of workers, raising overall living standards. The benefits of a strong dollar to consumers and import-using producers should not be sacrificed in a misguided effort to bring down the trade deficit. If the new administration and Congress are determined to do something about the trade deficit, they should act within those guidelines to avoid inflicting unintended harm on the economy.

If policymakers are convinced that the trade deficit must be reduced, they should avoid “solutions” that would do more harm than good.
Conclusion

America’s record trade deficit is not an economic problem. It is the benign consequence of a persistent surplus of foreign capital flowing into the United States. That additional capital has helped to make U.S. workers more productive, raising living standards above what they would be without it and building the foundation for future growth.

The trade deficit is not the cause of real or illusory problems in the U.S. economy but the result of strong growth and a healthy investment climate. By virtually every measure, U.S. economic performance during years in which the trade deficit rises is superior to that during years in which the deficit shrinks. In contrast to conventional wisdom, rising trade deficits are associated with faster growth, falling unemployment, accelerating manufacturing output, and reduced poverty. Specifically, there is no credible evidence that expanded trade and bilateral deficits with such trading partners as China cause a net loss of jobs. Nor is the trade deficit a threat to America’s future prosperity. America’s misnamed “foreign debt” is not a cause for concern when placed in the context of the size of the U.S. economy and the net wealth of U.S. households. The health of America’s economy depends on factors far more important than the size of the trade deficit.

The only real sense in which the trade deficit is a threat to the U.S. economy is its potential effect on public policy. Persistent worries about the trade deficit could prompt policymakers to implement a “cure” for the trade deficit, such as higher tariff barriers, that itself could impose serious damage on the economy.

The new administration and Congress should reject the idea of “balanced trade” as a policy goal. The best policy would be to ignore the U.S. trade deficit and concentrate on maintaining a strong and open domestic economy that welcomes foreign investment. As long as investors around the world see the United States as a safe and profitable haven for their savings, the trade deficit will persist, and Americans will be better off because of it.

Notes

6. This reality makes much of the Trade Deficit Review Commission’s testimony and report beside the point. In several sections of the commission’s report, the trade deficit was used as a proxy for a more general critique of U.S. trade policy. For example, Republican and Democratic members debated at length in the report the question of whether labor and environmental standards should be part of future trade agreements, with the Democrats supporting that approach and the Republican members opposing it, even though the question would have no direct impact on the trade deficit. Another entire chapter was devoted to the need for government assistance for displaced workers. Dozens of witnesses spoke in great detail about the impact of trade on various sectors of the U.S. economy. While all of those issues would be relevant to a discussion of overall U.S. trade policy, none of them was related to the causes and consequences of the U.S. trade deficit. Arguments about labor and environmental standards, antidumping law, sector adjustment, “fair trade,” and assistance for displaced workers would be exactly the same whether the U.S. balance of trade was in deficit or surplus.
9. Ibid., p. 103.


14. The USITC study did conclude that “the impact on the United States of the various tariff cuts considered is positive, but minor, in terms of growth in U.S. gross domestic product, total exports and imports, consumption and wages.” USITC, p. xi.

15. Ibid., p. xii

16. Scott, p. 3.


19. USITC, Table ES-4, p. xi.

20. TDRC, p. 169.


23. Ibid., Table 1, p. 53.

24. Ibid., p. 46.


30. Ibid., p. 869.

31. International Monetary Fund, p. 162.

32. TDRC, p. 172.


34. Ibid.
### Appendix: Economic Indicators and the Trade Deficit, 1973–99

<table>
<thead>
<tr>
<th>Year</th>
<th>Change in Current Account (% of GDP)</th>
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Continued
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Note: Changes in the unemployment rate and manufacturing jobs are measured December to December.
The mission of the Cato Institute’s Center for Trade Policy Studies is to increase public understanding of the benefits of free trade and the costs of protectionism. The center publishes briefing papers, policy analyses, and books and hosts frequent policy forums and conferences on the full range of trade policy issues.

Scholars at the Cato trade policy center recognize that open markets mean wider choices and lower prices for businesses and consumers, as well as more vigorous competition that encourages greater productivity and innovation. Those benefits are available to any country that adopts free-trade policies; they are not contingent upon “fair trade” or a “level playing field” in other countries. Moreover, the case for free trade goes beyond economic efficiency. The freedom to trade is a basic human liberty, and its exercise across political borders unites people in peaceful cooperation and mutual prosperity.

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“China’s Long March to a Market Economy: The Case for Permanent Normal Trade Relations with the People’s Republic of China” by Mark A. Groombridge, Trade Policy Analysis no. 10 (April 24, 2000)


“Tax Bytes: A Primer on the Taxation of Electronic Commerce” by Aaron Lukas, Trade Policy Analysis no. 9 (December 17, 1999)