



The Trade-Balance Creed Debunking the Belief that Imports and Trade Deficits Are a “Drag on Growth”

by Daniel Griswold

Executive Summary

A nearly universal consensus prevails that the goal of U.S. trade policy should be to promote exports over imports, and that rising imports and trade deficits are bad for economic growth and employment.

The consensus creed is based on a misunderstanding of how U.S. gross domestic product is calculated. Imports are not a “subtraction” from GDP. They are merely removed from the final calculation of GDP because they are not a part of domestic production.

Contrary to the prevailing view, imports are not a “leakage” of demand abroad. In the annual U.S. balance of payments, all transactions balance. The net outflow of dollars to purchase imports over exports are offset each year by a net inflow of foreign capital to purchase U.S. assets. This capital surplus stimulates the U.S. econo-

my while boosting our productive capacity.

An examination of the past 30 years of U.S. economic performance offers no evidence that a rising level of imports or growing trade deficits have negatively affected the U.S. economy. In fact, since 1980, the U.S. economy has grown more than three times faster during periods when the trade deficit was expanding as a share of GDP compared to periods when it was contracting. Stock market appreciation, manufacturing output, and job growth were all significantly more robust during periods of expanding imports and trade deficits.

The goal of U.S. trade policy should not be to promote exports at the expense of imports, but to maximize the freedom of Americans to trade goods, services, and assets in the global marketplace.

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Introduction

The merits of free trade may be hotly debated, but there is a near universal consensus on the objective of U.S. trade policy: to promote exports over imports. If the consensus were an organized religion, its creed would read something like this:

Exports are good, imports are bad. Exports create jobs, while imports subtract from output and employment. Imports represent a leakage of demand abroad. Every item we import is one less item we need to make ourselves to satisfy domestic demand. A growing trade deficit is, by definition, bad news for the economy, while a shrinking trade deficit is good news.

Judging by the economic press, this creed is almost universally affirmed. There are few dissenters in the trade community. Politicians, industry economists, stock-market analysts, business reporters and pundits—whatever their party or economic orientation—rarely contradict or question the creed.

Like ancient pagan rituals, its affirmation follows something of a lunar cycle—marked by the federal government’s monthly release of the latest trade numbers. Here is a sampling of headlines and dispatches over the course of the past year confirming the consensus:

Rising trade deficit could drag down U.S. recovery

—*USA Today*, July 13, 2010¹

Flow of imports drags down economic growth

—*Washington Post*, August 27, 2010²

“Trade was the biggest drag on the economy during the spring, subtracting 3.5 percentage points from growth.”

—CBS News, October 14, 2010³

“A widening [trade] deficit is bad for the

U.S. economy. When imports outpace exports, more jobs go to overseas workers than to U.S. workers. . . . The widening of the trade deficit cut one-half percentage point from overall economic growth last year [2010].”

—Associated Press, February 11, 2011⁴

“Many economists expect the deficit to be a drag on U.S. growth in the first quarter [of 2011] and possibly throughout the year. Higher imports can reduce overall economic growth by subtracting from demand for domestically produced goods and services.”

—*Wall Street Journal*, March 11, 2011⁵

Consensus opinion is not always wrong, but in this case it is. Contrary to the assumptions embedded in these and countless other reports, imports are just as beneficial to our economy as exports. Imports deliver lower prices and more variety to consumers while fueling competition, innovation, and productivity gains among producers. An expanding trade deficit is not necessarily a bad sign for the economy, but may (and often does) signal more robust domestic demand for goods and services, as well as rising investment and a larger inflow of foreign capital to finance it. Imports do not subtract from gross domestic product or displace overall domestic output. There is no evidence in our recent economic experience as a nation that imports or trade deficits have imposed a “drag on growth.”

Anxieties about imports and the trade deficit can lead to trade policies that do more harm than good. The constant refrain that imports reduce employment and slow the economy undermines public support for trade liberalization. It falsely paints trade as a zero-sum game, pitting nations against one another in a contest to export the most and import the least, with trade-surplus nations declared the winners. It tempts policymakers to believe that they can promote growth and employment by raising barriers to imports and restricting our freedom to trade with people in other countries.

This study will examine the thinking behind the belief that rising imports and trade deficits are bad for the economy. It will show how the consensus is mistaken in theory and how its assumptions conflict with the actual performance of the U.S. economy during the past three decades.

The Keynesian Consensus on Imports and Growth

Behind the consensus on trade and growth lies the simple logic that things we import take the place of things we could be making at home. Every car, end table, or pair of sneakers we import represents one fewer car, end table, or pair of sneakers that could have been “Made in the U.S.A.,” resulting in the layoff of American workers who were previously employed making those items.

In its more sophisticated form, the consensus rests on the Keynesian argument that prosperity depends on maintaining a sufficient level of domestic demand for goods and services. The greater the level of domestic demand, the more our factories, offices, and retail outlets will gear up to meet that demand, and the more workers they will need to hire to supply the demanded goods and services. In this framework, imports represent an unwelcome “leakage” of demand abroad.

Keynesian thinking on the economy can be boiled down to a well-known formula, the National Income Accounts Identity:

$$Y = G + C + I + (EX - IM)$$

In this formula, Y equals total national output, G equals government consumption, C equals private consumption, I equals investment expenditures, EX equals exports, and IM equals imports, with the expression $EX - IM$ representing the trade balance. If the two sides must equal, then according to basic math any increase in G , C , I or EX will raise Y , while an increase in IM will, by necessity (because of the minus sign), cause a decrease in Y . If exports rise, but imports rise even faster, the

trade deficit ($EX - IM$) will grow more negative, and the trade sector will “drag down” economic growth.

The U.S. Commerce Department’s Bureau of Economic Analysis feeds those assumptions in its quarterly reports on U.S. gross domestic product. In breaking down the components of growth, the BEA considers any increase in government consumption, private consumption, investment, or exports to be a positive contribution to growth in real GDP. Any increase in imports or the trade deficit is considered a subtraction from GDP.

Here’s how the BEA analyzed the various contributions to the change in 2010 real GDP in its January 28, 2011, report:

The increase in real GDP in 2010 primarily reflected positive contributions from private inventory investment, exports, personal consumption expenditures, non-residential fixed investment, and federal government spending. Imports, *which are a subtraction in the calculation of GDP*, increased.⁶ [Emphasis added.]

There you have it, from about the most authoritative source anyone could cite—the actual government agency that calculates changes in real U.S. GDP. Imports increased in 2010 and were thus, by impeccable Keynesian logic, “a subtraction in the calculation of GDP.” By the same logic, if imports had not increased in 2010, or if they had gone down, real GDP would have been larger, incomes higher, and more jobs created. Or so the trade-balance creed would lead us to believe.

Why Imports Do Not “Subtract” from GDP

At the heart of the misunderstanding over the trade deficit, imports, and growth is the indirect method the government uses to compute GDP for each quarter. The BEA estimates real GDP, not by counting what Americans actually produce, but by estimating expenditures on the various components

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of GDP and then inferring what we produce. The “subtraction” of imports is merely an accounting method to avoid overestimating domestic production.

Broadly speaking, the government estimates GDP by attempting to measure expenditures each quarter for private consumption, government consumption, investment, exports, and imports. The confusion flows from the fact that the government does not, and indeed cannot, distinguish expenditures on imported goods and services from those produced domestically in each category of GDP. Imports are baked into expenditures for *C*, *G*, *I*, and *EX* in a way that makes them indistinguishable from domestically produced goods and services. The only way to remove foreign product from gross *domestic* product is to “subtract” total imports from the final calculation.

Think of an economy based on a single product, which we can call a widget. The government estimates GDP by first counting the widgets purchased in the quarter for private consumption (*C*), government consumption (*G*), investment (*I*), or that are exported (*EX*). The problem is that once a widget enters the domestic market for sale, government accountants cannot distinguish a foreign widget from a domestically made widget. So *C* includes expenditures on domestic widgets as well as foreign widgets. The same goes for *G*, *I*, and even *EX*, since some widgets can be re-exported. The only way to determine gross domestic production of widgets in a given period is to subtract the total number of imported widgets from total domestic expenditures, adjusted for changes in inventories.

One of the clearest explanations of the role—or more accurately the non-role—of imports in calculating GDP comes from economics professor Steven Suranovic of George Washington University. On his website for his International Finance Theory and Policy course, Suranovic explains:

The correct argument, for why imports are subtracted in the national income identity, is because imports appear in the identity as hidden elements in con-

sumption, investment, government and exports. Thus, imports must be subtracted to ensure that only domestically produced goods are being counted. . . .

When consumption expenditures, investment expenditures, government expenditures, and exports are measured, they are measured without accounting for where the goods purchased were actually made. Thus, consumption expenditures measures domestic expenditures on both domestic and foreign goods purchased. For example, if a U.S. resident buys a television imported from Korea, that purchase would be included in domestic consumption expenditures. If a business purchases a microscope made in Germany, that purchase would be included in domestic investment. When the government buys foreign goods abroad to provide supplies for its foreign embassies, those purchases are included in government expenditures. Finally, if an intermediate product is imported, used to produce another good, and then exported, the value of the original imports will be included in the value of domestic exports. . . .

The reason imports are subtracted in the standard national income identity is because they have already been included as part of consumption, investment, government spending, and exports. If imports were not subtracted, GDP would be overstated. Because of the way the variables are measured, the national income identity is written such that imports are added and then subtracted off again.⁷

That is why imports are not a drag on GDP. When the Bureau of Economic Analysis reports that imports “subtracted” 3.5 percentage points from last quarter’s GDP, it does not mean that GDP would have grown 3.5 percentage points faster without those burdensome imports. It only means that the other components of GDP—private and gov-

ernment consumption, investment, and exports—were overstated by that same amount. The subtraction cancels out the overstatement, not real GDP.

The Circular Flow of Dollars and Demand

Those who worry about imports and the trade deficit as a drag on growth frequently warn against the “leakage” of demand abroad. To this way of thinking, the deficit represents a net outflow of wealth, a spilling of the economy’s vital lifeblood. What they miss is the reality that trade in its broadest sense is a circular flow. The money that flows out of our economy to pay for imports quickly flows back.

Foreign producers who sell in our markets are not ultimately motivated to acquire dollars, but to acquire what dollars and other currencies can buy. They may use the dollars earned from imports to the United States to exchange for other currencies, including their local currency, which they can use to pay their workers, suppliers, and shareholders. If the importer to the U.S. market does not want to use the dollars earned to buy U.S. goods, services, or assets, it will exchange those dollars in foreign-exchange markets to other parties who do.

Consider an everyday transaction. If an American spends \$50,000 to buy a Lexus from Japan, that transaction in isolation is considered bad for growth. It represents the leakage of \$50,000 in demand abroad. A vehicle gets made in Japan that could have been made in the United States, thus “more jobs go to overseas workers than to U.S. workers.” But the story does not end there.

Producers abroad are not content to stuff dollars in a cookie jar. If the \$50,000 is used to buy goods and services from the United States—say, soybeans, semiconductors, an insurance policy, or university tuition—our trade account is balanced. The demand for the Lexus is offset by the demand for U.S.-produced goods and services, and the consensus creed on trade is not offended. But the dollars earned abroad can also be used to buy U.S. assets—such as Treasury bonds, corporate stock, real estate, or a certificate of deposit at a U.S. bank.

In that case, we are running a \$50,000 trade deficit, but we are also receiving a net \$50,000 surplus in investment capital.

Like double-entry bookkeeping, every transaction entered in the debit column must be offset by an entry in the credit column. The \$50,000 spent on the imported car is offset by \$50,000 spent on the “exported” certificate of deposit or other asset. In this cosmic sense, our trade accounts are always balanced.

Balance of Payments: What Flows Out Must Flow Back

We can see the inherently balanced nature of America’s trade by examining the “balance of payments” accounts for the U.S. economy during the most recent calendar year. The current account is what draws the headlines. It covers our international trade in goods, services, investment income, and unilateral transfers, such as foreign aid and remittances. But transactions also include the financial account, which records the cross-border buying and selling of assets.

In 2010, a total of just under \$4 trillion flowed out of the United States to buy goods, services, and assets abroad, and just under \$4 trillion flowed into the United States to buy goods, services, and assets offered here.⁸ The hang-up for those who worry about the trade deficit is that the accounts do not balance within categories of transactions.

As Table 1 shows, there was a net outflow of money (a deficit) for transactions involving goods, unilateral transfers, foreign direct investment, and bank deposits. An equal amount of dollars, on net, flowed into the United States (we ran a surplus) on transactions involving services, investment income, non-bank claims, and portfolio investment, including government and private purchases of Treasury bonds, stocks, and other securities. (Because some transactions escape official recording, the accounts always include a “statistical discrepancy” to fully balance the ledger.)

During the past year, Americans ran up a \$470 billion deficit on the current account, including an even larger \$647 billion deficit in merchandise trade. Those figures grab the

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Table 1
No Leakage: U.S. Balance of Payments, 2010 (\$ billions)

	What Foreigners Bought in the U.S.	What Americans Bought Abroad	Balance by Sector
Current Account			
Goods	1,289	1,936	-647
Services	546	394	151
Investment income paid	662	499	163
Unilateral transfers, net		137	-137
Totals	2,497	2,967	-470
Financial Account			
Government-purchased assets	298	-6	304
Direct investment	194	346	-151
Securities, including stocks	510	167	343
Non-bank claims	50	-2	52
Bank deposits	192	519	-327
Derivatives, net	15	0	15
Totals	1,260	1,025	235
Statistical discrepancy	235		235
Total transactions	3,992	3,992	0

Source: Bureau of Economic Analysis, U.S. Department of Commerce. Figures may not sum to total due to rounding.

headlines, but during that same period foreigners directed a net inflow of investment to the United States of the same magnitude (after adjusting for the statistical discrepancy). The grand balance of all U.S. international transactions last year, as in every year, was zero. There is no leakage. What flows out through one pipe over the course of a year flows back through another.

The flows were not balanced within categories, and there is no reason why they should be. The preference for certain categories of items will vary by country, driven by differing rates of growth, levels of investment and savings, demographics, domestic regulations and taxes, and even culture. For all those reasons, demand for consumer goods will be relatively stronger

in one country, demand for investment assets relatively higher in another. There is no reason why Americans should want to spend exactly the same amount on foreign-made goods in a given year as foreigners want to spend on U.S.-made goods, just as there is no reason why trade in cars or agricultural products or insurance should be exactly “balanced” every year within their more narrow categories.

Exports Are Not the Only Stimulant

For those who are still worried that a trade deficit represents lost demand, they should consider that the foreign purchase of a U.S. asset can stimulate the U.S. economy just as well as the export of goods and services. A region of the United States that would benefit from the

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foreign purchase of \$1 billion in American-grown soybeans presumably also would benefit as much, if not more, were the \$1 billion invested in a foreign-owned automobile plant.

More broadly, the foreign-purchase of Treasury bills help to reduce long-term interest rates, stimulating the economy in the same manner as the Federal Reserve's policy of "quantitative easing." Foreign purchases of U.S. real estate and equities put dollars in the hands of those Americans who are selling the assets. Foreign demand can boost asset prices, stimulating the economy further through the "wealth effect," in which an improving balance sheet spurs families to spend more freely. Whether the dollars flow back to buy our goods and services or to buy our assets, economic activity is stimulated.

Advocates of the "exports are good/imports are bad" creed are half right: rising exports do deliver a boost to the U.S. economy. Demand abroad can help take up the slack when U.S. growth slows. Exports also allow U.S. companies to take full advantage of economies of scale. We can produce semiconductors, civil airliners, and pharmaceuticals at a lower cost per unit when we are selling to global markets rather than our more limited domestic market.

Where believers of the creed go wrong is in their failure to consider the benefits that imports bestow on the productive capacity of American companies and workers. Imports fuel American industry by providing the raw materials, intermediate inputs, and capital machinery our producers need to compete. Competition from imports spurs innovation, cost containment, and productivity gains, raising the potential growth rate of the U.S. economy.

The Losing Proposition of Protectionism

For all the reasons above, resorting to higher trade barriers as a means to promote growth will be doomed to fail. By reducing trade generally, trade barriers deprive our economy of the efficiency gains that come from specialization and economies of scale. Trade barriers drive up costs for consumers and for those industries that depend on im-

ports to produce their products for final sale, rendering U.S. companies less competitive in global markets.

Even for those who accept the creed that exports are the good half of trade and imports are the bad, trade barriers are a losing proposition. By reducing the flow of dollars out of the country to buy imports, trade barriers necessarily reduce the flow of dollars into the United States to buy our exports and our assets. A constricted outflow will mean a smaller supply of dollars in foreign exchange markets and a stronger dollar in terms of other currencies. A stronger dollar, in turn, will make imports more affordable, partially offsetting the indented effect of the trade barriers, while making U.S. exports more expensive for foreign customers. Higher U.S. trade barriers also invite retaliation by other countries, reducing the ability of U.S. producers to sell their goods and services abroad. The end result of rising U.S. protection would be the reduction of both imports and exports, leaving the trade balance unchanged while forfeiting the efficiency gains from trade. Trade barriers do not prevent leakage of demand. They merely restrict the healthy, circular flow of international trade in goods, services, and assets.

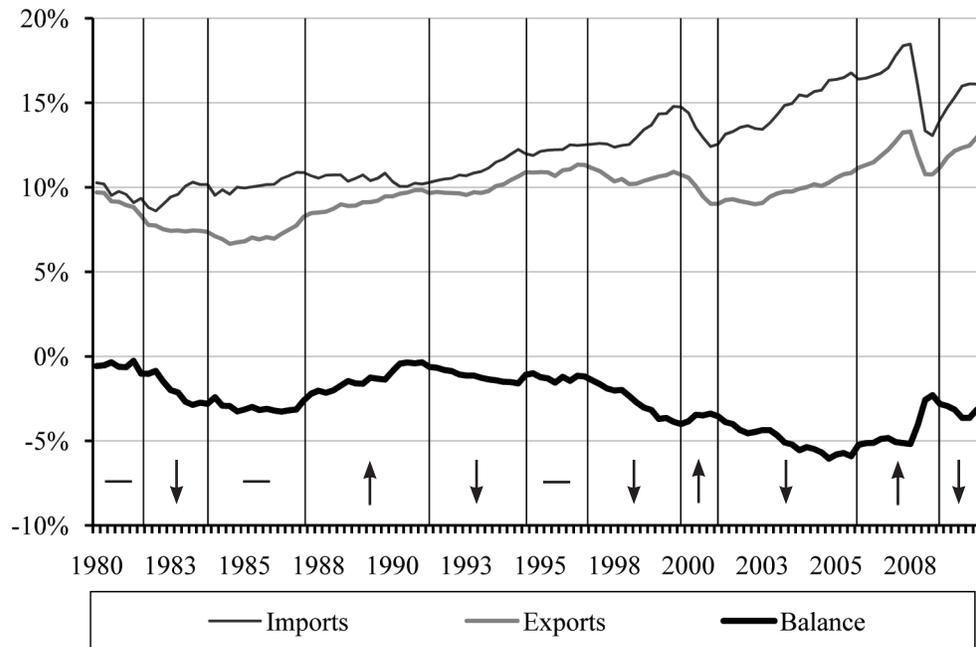
In sum, there is no compelling economic argument that rising imports or a growing trade deficit subtract from growth or signal a failure of U.S. trade policy. As the late economist Herbert Stein noted:

Contrary to the general perception, the existence of a current account deficit is not in itself a sign of bad economic policy or bad economic conditions. If the United States has a current account deficit, all this means is that the United States is importing capital. And importing capital is no more unnatural or dangerous than importing coffee.⁹

The stimulative properties of coffee aside, Stein's conclusion is grounded in solid economic reasoning and experience. A current-account deficit is no more worrisome for an economy than a surplus.

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Figure 1
U.S. Imports, Exports, and Trade Balance as a Percentage of GDP



Source: U.S. Bureau of Economic Analysis.

Testing the Creed: “Worsening” Deficits Often Signal an Improving Economy

The underlying assumption that imports are a drag on growth fails both in theory and in practice. If we consider the performance of the U.S. economy during the past 30 years, there is no evidence that a rising level of imports or a growing trade deficit has negatively affected the U.S. economy. In fact, the correlation appears to run in a direction opposite to that which the trade-balance creed assumes.

Assigning causation can be a difficult task, but we can nonetheless hold the creed up to a basic test: How does the U.S. economy perform when the trade deficit is growing compared to when the deficit is shrinking? If the creed reflects reality, then we could expect the U.S. economy to perform relatively better when the trade deficit is “improving,” since a

smaller deficit, all other things equal, is supposed to deliver a boost to growth, while a “worsening” deficit supposedly acts as a drag.

To see if there is any correlation between a changing trade balance and economic performance, this study examines the past 30 years of trade flows and various indicators of economic performance. Using quarterly trade and GDP data from the Bureau of Economic Analysis, we first calculate the trade balance in goods and services as a percentage of GDP. Then we look for trends in the trade deficit as a share of GDP, identifying periods of sustained expansion of the trade deficit and periods of sustained contraction.

Once the periods have been identified, we measure how the U.S. economy performed during each of those periods by using six common economic indicators that have a direct impact on the well-being of U.S. households: real GDP growth,¹⁰ inflation,¹¹ equity prices,¹² manufacturing output,¹³ civilian employment,¹⁴ and the unemployment rate.¹⁵ Then we compare the aggregate performance

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Table 2
The Trade Balance and U.S. Economic Performance, 1980–2010

Periods by Quarters			Trade Balance as % GDP				Economic Indicators, Annualized Change						
Start	End	Total	Start	End	Total Change	Change/Year	Real GDP	CPI	SP 500	Manufacturing	Employment	Jobless %	
Contracting Trade Deficits													
1987:4	1992:1	17	-3.1%	-0.4%	2.8	0.7	2.1%	4.4%	11.9%	0.9%	0.9%	0.4	
2000:4	2001:4	4	-4.0%	-3.4%	0.6	0.6	0.4%	1.9%	-18.2%	-5.5%	-0.8%	1.6	
2006:3	2008:3	8	-5.9%	-5.2%	0.7	0.4	1.0%	3.8%	-1.4%	-1.2%	0.2%	0.7	
2008:3	2009:2	3	-5.2%	-2.3%	2.9	3.9	-4.1%	-3.0%	-36.3%	-16.1%	-4.5%	4.4	
Weighted Averages						0.9	1.0%	3.3%	0.3%	-2.0%	0.0%	1.0	
No Trend													
1980:4	1982:2	6	-0.4%	-0.3%	0.1	0.1	0.1%	8.0%	-9.8%	-3.2%	0.2%	1.3	
1984:4	1987:4	12	-2.8%	-3.1%	-0.3	-0.1	3.8%	3.1%	15.6%	3.9%	2.3%	-0.5	
1995:2	1997:3	9	-1.6%	-1.2%	0.4	0.2	4.3%	2.5%	29.1%	6.8%	1.9%	-0.4	
Weighted Averages						0.0	3.1%	4.0%	14.5%	3.3%	1.7%	0.0	
Expanding Trade Deficits													
1982:2	1984:4	10	-0.3%	-2.8%	-2.5	-1.0	5.2%	3.8%	15.9%	6.0%	2.4%	-0.8	
1992:1	1995:2	13	-0.4%	-1.6%	-1.2	-0.4	3.2%	2.9%	7.7%	5.2%	1.7%	-0.5	
1997:3	2000:4	13	-1.2%	-4.0%	-2.8	-0.9	4.1%	2.5%	12.5%	4.6%	1.7%	-0.3	
2001:4	2006:3	19	-3.4%	-5.9%	-2.5	-0.5	2.8%	2.9%	3.0%	3.0%	1.3%	-0.2	
2009:2	2010:4	6	-2.3%	-3.2%	-0.9	-0.6	3.0%	1.4%	22.1%	7.3%	-0.6%	0.2	
Weighted Averages						-0.6	3.6%	2.8%	11.3%	5.2%	1.4%	-0.4	
Averages, 1980–2010								2.8%	3.2%	7.6%	2.5%	1.1%	0.1

Sources: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; Wells Fargo Advisors; Federal Reserve System.

of the economy during periods when the trade balance is turning more negative vs. periods when it is turning more positive.

30 Years of Rising and Falling and Rising Deficits

Since 1980, the U.S. trade deficit has grown as a share of GDP during five sustained periods: 1982–84, 1992–95, 1997–2000, 2001–06, and 2009–10. It has contracted as a share of GDP during three periods: 1987–92, 2000–01, and 2006–09. And it has moved laterally without a trend during three periods: 1980–82,

1984–87, and 1995–97.¹⁶ The various periods can be observed graphically in Figure 1.¹⁷ A down arrow marks a period in which the trade balance was turning more negative (that is, the trade deficit expanded), an up arrow a period when the balance was turning more positive (that is, the deficit was shrinking), and a dash a period with no sustained trend.

Once the periods are identified, we can measure the economic performance during each by comparing how the six economic indicators changed during the period. Table 2 shows the annualized change in the indicators during

By every measure and by wide margins, the U.S. economy performed better when the trade deficit was growing than when it was declining.

each of the periods. The periods are grouped according to the trend in the trade deficit. For each type of trend, we can calculate the average performance of the economy, weighted according to the length of each period.

What the past 30 years show is that the U.S. economy exhibits no sign of suffering during periods when the trade deficit is expanding. To the contrary, the U.S. economy grew more than three times faster during periods when the trade deficit was expanding as a share of GDP compared to those in which it was shrinking.

Stocks, as represented by the Standard and Poor's 500 Index, climbed an annualized average of 11 percent during periods when the trade deficit was "worsening," compared to a less than 1 percent annual advance during periods when the deficit is "improving."

Despite worries about the impact of the trade deficit on the U.S. industrial base, manufacturing output expanded a robust 5.2 percent a year during periods of rising deficits, in contrast to a 2.0 percent decline when the deficit was contracting.

Trade deficits are routinely blamed for job losses, yet civilian employment grew a healthy 1.4 percent annually during periods of rising trade deficits while job growth was virtually zero during those periods when the deficit was declining. Ditto for the unemployment rate. The jobless rate ticked down 0.4 percentage points per year on average when the trade deficit was on an upward trend, and jumped a painful 1.0 point per year when the trade deficit was shrinking. In four of the five periods in which imports did outpace exports, the unemployment rate fell, and in every period in which imports grew more slowly than exports, or fell more rapidly, the unemployment rate rose.

The annual inflation rate was slightly higher during periods of a contracting deficit compared to an expanding deficit, but the difference was small and probably not significant.

The three periods when there was no real trend in the trade balance were comparable in economic performance to those during which the deficit was rising and were far better than the periods when the deficit was shrinking. It

is worth noting that the two most recent periods of lateral movement in the trade deficit, 1984–87 and 1995–97, both followed periods of an expanding deficit, with the deficit reaching a plateau at a relatively high level. Yet the economy in each of those two periods performed rather well. (Examining periods of rising and falling imports as a share of GDP reveals the same unambiguous contradiction of the current consensus.¹⁸)

Although the creed would imply that declining deficits should accompany economic expansions, they are invariably linked with recessions. In fact, all three of the periods of declining trade deficits include the three most recent recessions. The Great Recession of 2008–09 coincided with the sharpest "improvement" in the trade deficit in the past 30 years. That is small comfort to the eight million Americans who lost their jobs during the recent downturn.

The aggregate numbers are not skewed by outliers. Real GDP grew faster in every period of rising deficits compared to even the best-performing period of declining deficits. Manufacturing output and the unemployment rate improved more favorably in every period of rising trade deficits compared to any period of declining deficits. By every measure and by wide margins, the U.S. economy performed better when the trade deficit was growing than when it was declining.

The Great Recession and the Trade Deficit

The past decade brings the contradictions of the creed into stark relief. The U.S. trade deficit grew steadily from the fourth quarter of 2001 through the third quarter of 2006. Five straight years of growing trade deficits prompted then Speaker of the House Nancy Pelosi and a number of fellow Democrats to send a letter to then President George W. Bush in February 2007 describing the grim consequences:

The United States has run record-setting trade deficits for each of the last five years. The consequences of these persistent and massive trade deficits include not only failed businesses, displaced workers,

lower real wages, and rising inequality, but also permanent devastation of our communities.¹⁹

How did the U.S. economy in fact perform during those five years? About average. Annualized GDP growth in 2001–06 was the same—2.8 percent—as the overall average since 1980. The stock market underperformed, but manufacturing output, job growth, and the unemployment rate all performed slightly better than average.

At about the time that letter was being sent, the trade-deficit trend was already turning. From the fourth quarter of 2006 to the third quarter of 2008, the trade deficit shrank modestly in nominal terms and as a share of GDP, while the economy began to slow. During that two-year period, every one of the six economic indicators worsened: growth slowed sharply to 1 percent, the stock market lost ground, manufacturing output began to decline, and the unemployment rate began to climb. Even inflation ticked up.

All those negative trends accelerated brutally as the financial crisis and recession of 2008–09 deepened. While the trade deficit was “improving” by giant strides, the economy from the fourth quarter of 2008 through the second quarter of 2009 was falling off a cliff. Real GDP growth, the stock market, manufacturing, and employment all suffered their sharpest declines since the Great Depression. Inflation turned briefly to deflation. (Even though the trade deficit was shrinking throughout the 2006–09 period, Table 2 shows both phases so that the severity of the 2008–09 downturn can be appreciated.)

Predictably, given the pattern of the past 30 years, the trade deficit has begun to grow again, starting in the third quarter of 2009, as the economy itself has gradually recovered.

If the Democratic letter accurately described the U.S. economy from 2001 to 2006, when the trade deficit was rising, how would a follow-up letter describe the U.S. economy from 2006 to 2009, when the trade deficit shrank by more than half? The honest answer is that the picture would be far more grim.

Apparently the only thing worse for the U.S. economy than a rising trade deficit is a falling deficit.

Conclusion

Something is clearly amiss in the conventional thinking about the trade balance and economic growth. It is beyond the scope of this paper to offer a general critique of Keynesian economic thinking, but the common notion in trade circles that imports and trade deficits are a drag on growth does not withstand scrutiny.

In theory and in practice, rising imports, or a rising gap between imports and exports, does not hinder economic growth, stock market appreciation, manufacturing output, or job creation. In fact, all the evidence points in exactly the opposite direction. Misguided efforts to restrict imports to cure the trade deficit would cause far more harm than good to the U.S. economy.

More than two centuries ago, in his great dissent from the prevailing mercantilist creed of his day, Adam Smith wrote that “Nothing . . . can be more absurd than this whole doctrine of the balance of trade, upon which, not only these restraints, but almost all the other regulations of commerce are founded.”²⁰ Frederic Bastiat, another dissenter writing in the middle of the 19th century, declared that “The balance of trade is an article of faith,”²¹ lacking any basis in sound economics.

The time to reform the prevailing doctrine of the trade balance is long overdue. The goal of U.S. trade policy should not be to maximize exports and minimize imports in a misbegotten quest for “balanced trade.” The goal should be to maximize the freedom of Americans to buy and sell in global markets for mutual gain, whatever the mix of goods, services, and assets we freely choose to trade.

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Apparently the only thing worse for the U.S. economy than a rising trade deficit is a falling deficit.

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 18. As Figure 1 shows, periods of rising imports roughly track periods of rising trade deficits, with certain differences determined by variations in exports. Applying the same analysis to imports finds that the gap in economic performance is even wider, with periods of rising imports as a share of GDP far superior, on average, to those periods in which imports were falling. Curiously, the performance gap almost disappears between periods of rising and falling exports.
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