The Deficiencies of Trade Deficits
by Don Redekop

The Japanese current account deficit is reported to be $4.5 billion to date this year. The British deficit is £2.5 billion. Canada’s is projected to be $7.0 billion in 1979. And in the United States, every month now for more than three years the value of imports has exceeded the value of exports, which is to say that it too has a current account deficit.

The value of U.S. imports over exports in 1978 was $28 billion; in 1979 the differential is expected to be $22 billion. Five of the past 11 years have registered such a differential.

The current account deficit is the measure of payments for goods and services purchased abroad over and above payments received from abroad for goods and services purchased in America. The difference must be borrowed or financed by drawing down reserves of gold and foreign currencies. If the deficit persists, reserves will run out and borrowing must start. This borrowing is reflected in the capital account.

What is the relationship of the deficit to the value of the currency abroad and at home? What does it say of the health of trade patterns? The public discussion is generally surrounded by sounds of distress—distress over our ability to maintain living standards and jobs in the face of what appears to be an irreversible slide into the slough of economic despond. The New York Times of August 29 says of the deficit:

Exports...continued to be sluggish as American industry struggled to be competitive with other industrial nations....American exported goods have not been competitive, either for lack of marketing effort or because their prices have gone up with inflation. At the same time, American consum-

ers have continued to buy foreign goods despite their higher prices.

All is lost. Or is it? A quick examination of the current and capital accounts is in order.

Some simple observations about these accounts:
1. The current and capital accounts are a form of double entry bookkeeping. Together with the reserves held by the Federal Reserve (a catch-all accounting item), they make up the balance of payments. The balance of payments must balance by definition. (Usually when journalists refer to a “balance of payments deficit,” they are referring to the current account deficit.)
2. The current account is divided into goods and services accounts (or visibles and invisibles). These items can in turn be divided further into any number of classes. A typical breakdown is merchandise, travel, interest and dividends, and freight and insurance. A “deficit” then may refer to the current account or some component of it.

The New York Times is correct in its observation that American consumers have continued to buy foreign goods despite their higher prices. Oil is a case in point and is an often selected example of American inelasticity of demand in response to price. Oil, in fact, has caused most industrial nations in recent years to undergo a current account deficit.

What is the result of an increase in the price of oil? Although the quantity of oil imported falls, the inelasticity of demand means that expenditures on oil will rise. The increase in expenditures increases the current account deficit to the extent that OPEC nations build up their reserves of American dollars rather than purchase American exports. Since the OPEC governments want a diversified portfolio of assets, in the short run they have more dollars than they want to hold. In their attempt to get rid of these dollars in return for other currencies, they drive down the value of the dollar in terms of these currencies. That is, the exchange rate falls. It falls until it reaches the point where the amount of dollars people want to hold equals the amount of dollars in existence. The adjustment of the exchange rate solves the deficit “problem.”

The self-equilibrating nature of this process means that policy geared toward correction of the symptoms of a rising current account deficit is mis-

Don Redekop, an attorney, is assistant to the president of the Toronto Stock Exchange.
The October 22 Village Voice carried a story critical of “free enterprise” think tanks and of the academics whose research they fund. Entitled “The Counter-Intelligence: The ‘Free Enterprise’ Think Tanks and the Holy War on Government,” the article leaves the reader with the impression that this is nothing sinister going on. It deserves an answer.

The author, Peter Stone, tries to discredit the free market by casting aspersions on the economists who argue for it and on the foundations that finance much of their work. He quotes approvingly a Nader associate’s claim that these economists are “corporatist academics” who are “trying to give legitimacy to the corporate worldview.”

What is the “corporate worldview”? The term connotes a world run by giant soulless corporations that swallow up the individual. But that is simply Mr. Stone’s view of where the free market would lead. Those of us who write the analyses Mr. Stone criticizes have a different view of the free market. We believe that the individual has a better chance to fulfill his potential when he is free to engage in voluntary exchange than when the government tells him what exchanges he may make and on what terms he may make them.

We have much evidence for this belief. We can point to the minimum wage, a program that prices many poor people out of the labor market (see “The Minimum Wage” in this issue). We can point to Interstate Commerce Commission (ICC) restrictions that prevent people from entering the trucking business and that lead to higher freight rates. We can point to the military draft, which forced unwilling people into uniform and excluded women who really wanted to be in the military. We can point to the harmful effects of many such restrictions on freedom.

Mr. Stone obviously doesn’t believe that the individual will fare well in a free market. But rather than countering the arguments and evidence of the market’s proponents, he dismisses them as paid hacks. I doubt that many of them are paid hacks. Most are people with particular viewpoints who are hired by foundation funders. The validity of their arguments does not depend on the source of their funding. We cannot dismiss their arguments because they were paid to make them anymore than we can dismiss Mr. Stone’s arguments because he was paid to make them. But in Mr. Stone’s case, there is nothing to dismiss. He gives no arguments.

What about the facts that support this research found in Mr. Stone? Mr. Stone gives the impression that they stand to gain from the foundations’ general free-market orientation. But again, the issue of whether their motives are narrowly self-interested or genuinely idealistic has no bearing on the worthiness of their cause. By way of analogy, Hugo Hefner may give financial support to defend freedom of the press and he may do this entirely to save the freedom of his own publishing. But on this basis that freedom of the press should not be defended?

Mr. Stone gives the impression that research critical of government regulation is done only by academics at a handful of universities. And even academics who do not themselves actually engage in research critical of government often accept the conclusions of those who do.

Belief in the free market cuts across traditional ideological lines. Many modern liberal economists are among the most vociferous critics of government regulation. For instance, Paul MacAvoy, a McGovern supporter in 1972, spent most of his time on former President Ford’s Council of Economic Advisers fighting regulation. Charles Schultz, the current chairman of the Council, is a strong critic of price supports in agriculture. Walter Hukin, chairmen of the Council under Presidents Kennedy and Johnson respectively, signed a statement at President Ford’s 1974 economic summit calling for the elimination of (1) contracts on the production and pricing of oil, (2) price controls on natural gas, (3) ICC restrictions on entry and rates in surface freight transportation, (4) CAB restrictions on entry and rates in air transportation, (5) Federal Maritime Commission regulation of shipping rates, (6) restrictions of investment payments on checking accounts, (7) federal cartelization of agriculture markets through marketing orders and price supports, (8) import quotas, (9) FCC regulation of cable TV and a number of other regulations. Twenty-one of the 23 economists who attended the summit signed the statement. Among the other signers were Paul Samuelson, former an adviser to President Kennedy and Robert Kennedy, and currently an adviser to Senator Kennedy; and Andrew Brimmer, former head of the Federal Reserve Bank of New York. Only John Kenneth Galbraith and the AFL-CIO’s Nathaniel Goldfinger were naysayers.

Those who are pessimistic about the chances for individualism should take heart from Mr. Stone’s article. His approach suggests that he knows he cannot answer our arguments. If his article is typical of what we are up against, then our chances look very good indeed.

'The very idea that there ought to be a balance in any sector is sterile.'

The prescription of a market free of interventions, free to seek its own level, is a much more difficult claim than it sounds, for it does rest in fact avoid the following difficulty: What is the market or “natural” level of exchange and interest rates, when this market is encircled with public policy barriers and corroded by inflation? Only if the government were completely absent from the money market would we know the market level of exchange and interest rates. Since the government is not likely to stop intervening soon, no second-best solution is compelling.

Two other problems may illustrate the difficulty in understanding a current account deficit.

1. There is a sense in which the fear of current account deficits is justified. Deficits in the current account must be matched by surpluses in the capital account. A capital account surplus means that we borrow more from foreigners than they borrow from us. Who is responsible for the borrowings that finance present consumption? If corporations are doing the borrowing, the process is rapidly self-limiting. Debt capacity becomes strained, and the cost of new credit becomes a disincentive to further debt. The possibility of bankruptcy prevents such borrowers from becoming hopelessly overextended. If the borrower, on the other hand, is a government, the discipline of diminishing means is far removed. True, its creditors may become wary, but

POLICY REPORT

Trade Deficits (Cont. from p. 1) guided. To subsidize exports and to discourage imports, for example, in order to control a current account deficit, one would increase those signals. The equilibrium that would have been achieved will not be achieved.

But precisely such measures are often suggested to government in order to deal with the following mutually exclusive fears:

1. The fear that the exchange rate adjustment will be ineffective in changing people’s demands.

2. The fear that the effect of a shift in the exchange rate is too abrupt and too costly in terms of temporarily accelerating and breaking the small governing domestic production and, with its domestic incomes.

The picture of alternative policy aims is far more complicated by each other as variables interest rates, growth of the domestic money supply, and Federal Reserve operations to support the dollar at a given level in terms of other currencies. Government control over each of these variables is exercised to accomplish other goals antagonistic to the floating exchange rate equilibrium.

The two fears about exchange rate effectiveness in “balancing” trade lead to mutually antagonistic policy proposals for both sides of the deficit. When other government-controlled ingredients are thrown into the public policy battle, the results can be highly indi-

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Trade Deficits (Cont. from p. 3)

2. Policy makers are often tempted to segregate further the components of the current account to isolate the factors that "caused" the deficit. This effort, wrongly proceeds on the assumption that the cause of the deficit is the largest dollar components of the current account deficit or largest sectors in the ratio of exports to imports of a particular industry or product. This error then leads to proposals for policy that "caused" the deficit. This effort wrongly proceeds on the assumption, as in the Times article quoted, that only a more strenuous marketing effort is required for that domestic sector to improve its performance.

To attempt to avoid sectoral imbalances, is, more fundamentally, to mis-understand the necessarily dynamic nature of an economy. Technologies are born and they die. Industries appear and disappear. To avoid a sectoral imbalance in the manufacture and export of buggy whips is to freeze technology and tastes forever. To avoid a cur- rent-account deficit requires the same degree of voluntary action required in the case of the Times article quoted, that only a more strenuous marketing action is required for that domestic sector to improve its performance.

The Minimum Wage

The minimum wage is scheduled to rise from $2.90 to $3.10 an hour on January 1. Whenever federal government workers are to receive a pay increase, they claim it will raise the wages of all workers currently working for less than the minimum. Their claim is untrue. Many of these workers will find their wages reduced— to zero— since they will lose their jobs. The government's estimates ignore the fact that the number of people who are working is inversely related to the wage employers must pay.

Imagine an employer deciding whether to retain a worker currently being paid at the $2.90 an hour level. If the employer cuts the wage to $3.10, the employer will retain him and the worker will be better off. This is the simple story that many proponents of minimum wages tell, and their story ends here. But alas, the true story does not end here. Hourly output is probably not worth $3.10. It is probably worth about $2.90, the current wage. If the employer had tried to pay the worker less than his value, the rival employer would have spotted a profit opportunity in making a slightly higher wage and making a profit equal to the difference between the value of the laborer's worker and the wage. As long as there is such a difference, the wage is not a profit opportunity for a rival employer. Therefore, the wage will be bid up until no further profit opportunity remains. The wage will equal the value of the worker's output. In economists' jargon, competition by employers drives workers' wages to equality with the value of their marginal product.

Since the value of the worker's product is about $2.90, the employer will fire some workers rather than retain them at $3.10 and lose money. Some, but not all. Laying off some workers raises the amount of capital per worker, making remaining labor more productive. It is therefore not an often arbitrary decision. This will happen throughout the economy. The effect on employment of an increase in the minimum wage is unambiguous.

Many marginal, unskilled workers will lose their jobs. Thus my contention that the new law will reduce many workers' wages is unambiguous.

Most studies of the effects of mini- mum wages have found a disin- mployment effect. Every time the minimum wage rises, the employment of marginal workers drops, and then rises slowly as inflation and increases in worker productivity ameliorate the law's effect. Some studies have failed to find this effect of the minimum wage on unemployment, but this is a consequence of the way unemployment is measured. A member of the labor force is defined as if he is out of work and actively seeking work. Many low-productivity workers who lose their jobs because of the minimum wage become discouraged and drop out of the labor force. That these workers are not counted as unem- ployed is small comfort to them; they are not only out of work but out of the minimum wage.

This analysis does not turn on the employer's being unable to afford the minimum wage. The worker does not have to be Rockefeller and he would still fire workers whose productivity was less than the minimum wage. The disem- ployment effect of minimum wages results not from the poverty of employ- ers but from the low productivity of some workers.

The minimum wage also turns jobs that combine low wages with on-the-job training into higher wage, dead-end jobs. An employer offering a wage of $2.10 an hour plus on-the-job training may receive a worker who would prefer the on-the-job training if forced to pay $3.10. A recent study by Harvard economist Martin Feldstein reports a significant "dead-end" effect.

These adverse effects of the mini- mum wage are serious, especially for young blacks. A significant fraction of the current generation of blacks will never be black because of the minimum wage.

In the view of these effects, why have so many politicians advocated increasing the minimum wage? It is due to their ignorance. Probably not. Whenever hearings are held on minimum wage increases, economists of varied ideological stripes point out the adverse consequences. But there is one effect politicians from the Northern states are very much aware of: the impact of the minimum wage on industrial competition. From low-wage Southern states, Senator John Javits of Northern New York asks NAACP's Mr. Mitchell why he said: I point out to Senators from industrial states like my own that a minimum wage increase would also give industry in our states some measure of protection, as we have too long suffered from the unfair competition based on sub- standard wages and other labor condi- tions.

(Cont. on p. 7)
Minimum Wage

Washington Update

The Congress hopes to finish business by December 14, but a prodigious amount of legislation remains for both the House and the Senate. Among the major bills before the House and the second budget resolution (which Congress should have passed by September 25— as required by law), the Energy Security Corporation, the Chrysler bailout, the wincal protasis tax, welfare reform, and hospital cost containment. The Senate also faces all these and much more. Target date for convening the second session is January 22, 1980. Veteran Congress watchers await the last few hectic days with some trepidation: The Congress usually pushes through some Christmas trees in the waning hours, and this year may be an entire forest.

"Sunset" legislation is likely to be on the 1980 calendar. Senator Muskie of the Governmental Affairs Committee is the prime mover— his bill would require congressional review of federal programs every 10 years. A similar bill held the Senate last year and died in the House.

The House's resounding rejection of the sugar bill in October led to a sharp decline in sugar prices. Economists believe that the sugar bill is one of the few issues in Congress in anticipation of passage of the bill, which would have raised price supports. The event was a classic example of how congressional action directly and significantly affects prices.

The phantom recession continues, and economists are becoming more perplexed than ever over the conflicting signs in the economy. Meanwhile, the Federal Reserve, ostensibly tightening the money supply, has tripled the loans through the discount window at interest rates well below the prime rate. Spokesmen for the Fed deny that this indicates a liquidity problem for some banks, but the Comptroller of the Currency warned the American Bankers Association that we must be prepared for the failure of major banks.

A bill to end the Secretary of the Treasury's power to compel delivery of all privately held gold bullion, coins, and certificates to the Treasury was acted on by a Subcommittee of the House Banking Committee in October, and will probably have been passed by the House by December. The bill has been on the books since 1934.

NOW accounts, share draft accounts at credit unions, and automatic transfer accounts are threatened by a federal court ruling that they are illegal. Congress has until the end of the year to change the law, but the Senate has combined the needed change with a bill incorporating many substantive changes in the banking system. The delay and the dispute between the two Senate versions of the matter could end NOW accounts held by thousands in New England and New York.

In other matters, the House Banking Committee reported out a solar energy bill early in November—a sign, perhaps, that the sun is shining down even though the banking system stumbles in deepening twilight?

Congress performed a neat trick when it voted on the continuing appropriations resolution. Because of the failure of the Senate to enact several appropriations bills for fiscal year 1980 (which began October 1, 1979), the Congress passed a stopgap appropriations resolution during October. The resolution included funds for most agencies until November 20, but the expiration date was omitted from the section appropriating money for Congress. Among other things, that relieves Congress from voting again on its 5.5 percent pay raise.

The White House is lobbying intensively—and illegally—for price controls on hospitals, the so-called hospital cost containment bill. It is the centerpiece of the Administration's program on inflation, and both President Carter and Vice President Mondale have entered the battle by personally calling members of Congress.

Many House members are receiving increasing amounts of mail against the creeping deregulation of the trucking industry, now being carried out by the Interstate Commerce Commission. Virtually no mail has been favorable to the Commission's actions. Ironically, chances for passage of a law deregulating trucking are improving one may be on the books by next summer, since the operators, truckers and the Teamsters now feel that they can get a better chance when they go to Congress than the ICC.

The Carter-Kennedy plan would end hauling and route restrictions and would make market entry and rate changing easier.

In a spectacular display of idiocy, the Department of Energy is planning to buy domestically produced crude oil and store it in salt domes in Louisiana and Texas. OPEC has forbidden any further purchases of its oil for such "non-commercial" purposes, and the DOE plans to buy crude from domestic producers and to drain the Naval Petroleum Reserve. The Strategic Petroleum Reserve, which was mandated by Congress in 1975 now has pumps to get the oil out of the salt domes where it has been poached (91 million barrels of U.S. storage, unfortunately, there is no distribution system, but the government can at least get some of the oil to the surface, an improvement in the system since last summer).

Challenged before the Supreme Court in Adams v. Children's Hospital, in 1923, one of the plaintiffs was a woman thrown out of work by the law.

David R. Henderson is the editor of Policy Report.

Editor's Column

Let's Look at the Record

"In 1932, American voters threw President Hoover out of office because of a feeling that the federal government was not energetic enough to pull the economy out of the Great Depression."


The implication of this quotation is that the 1932 electorate, offered a clear choice between Hoover's Republican and the Democratic Party's call to commit the federal government to do more to pull the economy out of the Great Depression, preferred the latter.

The record on this score, however, was set straight back in 1935 by James P. Warburg in his Hall's Best for Election. The following excerpt provides some illuminating facts as to what the 1932 voters were offered (and by whom), what they voted for, and what they got.

"Let us have a look at some promises made in 1932.

Unemployment and Labor Legislation

1. A federal appropriation of $300,000,000 for immediate relief for those in need, to supplement state and local appropriations. (This promise seems to have been adequately fulfilled by the FERA.)

2. A federal appropriation of $50,000,000 for public works and roads, reforestation, slum clearance, and decent homes for the workers, by federal government of work and cities. (This promise seems likewise to have been fulfilled by the PWA and CCC.)

3. Legislation providing for the acquisition of land, buildings and equipment necessary to put the unemployed to work producing food, fuel and clothing and for the erection of housing for their own use. (Something of this sort is being tried in various experimental communities in one of which Mrs. Roosevelt has taken a great interest; likewise, the Under Secretary of Agriculture, Rexford Tugwell, is working on these in the latter.)

4. The six-hour day and the five-day week without a reduction of wages. (The Hall bill for the establishment of a thirty-hour week was not passed by Congress.)

5. A comprehensive and efficient system of free public employment agencies. (A comprehensive system has been established; its efficiency is a matter of opinion.)

6. A compulsory system of unemployment compensation with adequate benefits, based on contributions by the government and by employers. (The Social Security Act provides for such a system with additional contributions by employees.)

7. Old age pensions for women and men sixty years of age and over. (Provided by Social Security Act for those over sixty-five years of age.)

8. Health insurance. (Provided by Social Security program.)

9. Improved systems of workmen's compensation and accident insurance. (See Senate bill 279, introduced May 9, 1939, by Senator Wagner.)

10. The abolition of child labor. (See NRA and proposed constitutional amendment.)

11. Government aid to farmers and small home-owners to protect them against mortgage foreclosure, a moratorium on sales for nonpayment of taxes by destitute farmers and unemployed workers. (This promise was more than fulfilled, since a moratorium was extended not only for nonpayment of taxes but also for nonpayment of interest and principal of mortgages.)

12. Adequate minimum wage laws. (These were established by the NIRA.)

None of these and the Frazier-Lemke Mortgage Moratorium Act were subsequently declared unconstitutional by the Supreme Court, but this does not alter the fact that Mr. Roosevelt tried to fulfill the promises involved in these two pieces of legislation.

So far, on the face of it, the above looks like a pretty complete record of fulfillment—in fact, an excellent record. Why is it not, then, an excellent argument for Mr. Roosevelt's reelection? Because it is a record of fulfillment, not of promises made by Mr. Roosevelt or by the Democratic party, but a record of fulfillment of the promises made by the socialistic candidate, Mr. Norman Thomas.

The weate words 1 have just enumerated are worded for word the first twelve planks in the platform of the Democratic party on which Mr. Thomas ran in 1932 and polled less than nine hundred thousand votes.

Does that surprise you?

As far as the question of what the Democratic platform had to say on such subjects. Here are the planks on which Mr. Roosevelt polled almost twenty-three million votes.

1. "An immediate and drastic reduction of governmental expenditures by a reduction of the unnecessary, nonproductive commission and sub-offices, consolidating departments and bureaus and eliminating extraneous expenditures with a saving of cash at least 25 percent in the cost of federal government; and we call upon the citizens of the State of New York in the State Legislature to make a zealous effort to achieve a proportionate result." 2. "The fixing of the national credit by a federal budget annually balanced on the basis of accurate executive estimates, within revenues, and not by a system of taxation levied on the principle of ability to pay."
And who has been paying all along? Prime Minister Margaret Thatcher’s Conservative government detailed deep public-spending cuts that will significantly curtail Britain’s welfare-state services.... Parents and students will have to start paying for school meals, milk and transportation in many places. National Health Service patients will be charged higher dental fees and about $1.50 instead of about 50 cents to fill a prescription.

—Washington Post, Nov. 2, 1979

Fair is foul and foul is fair... A new Carter crackdown on oil companies? Adviser Eizenstat quotes King Lear: “I will do such things, what they are yet I know not, but they shall be the terrors of the earth.”

—Wall Street Journal, Nov. 2, 1979

The friendly skies Some proponents of airline deregulation who expected it to produce lower regular fares have been disappointed. Instead, due in large part to inflation and higher fuel costs—and possibly insufficient competition on many routes—regular ticket prices have increased 27.5 percent this year.

Offsetting this, however, have been the many discounts, including $99 flights between New York and Los Angeles, and $20 flights between Houston and New Orleans. About half of all travelers use some kind of discount.

When all the fares are put together, regular fares and discounts alike, the cost of air travel has risen more slowly since 1977 than the cost of living index.


Unfortunately, yes Ronald Reagan, who will formally announce for President in less than two weeks, said Thursday he is becoming less and less amused by reports that his advisers are trying to create a “new image” for him.

“I am what I am,” the 68-year-old former California governor told reporters at International Airport, “and I think all of you know what my positions are on the basic issues.”

—Los Angeles Times, Nov. 2, 1979

How sweet it is A consumer-minded House of Representatives dealt the sugar producers’ lobby a defeat today by refusing to raise sugar-price supports. By a vote of 249 to 158, the House turned back an attempt to guarantee sugar growers a minimum price of 16.3 cents a pound.


Hear, hear! The British government introduced a bill in Parliament aimed at protecting British companies from some provisions of U.S. antitrust law. The bill also would enable companies in the United Kingdom to ask British courts to return punitive damages assessed by U.S. courts under the Sherman Antitrust Act....

John Nott, Britain’s Secretary of State for Trade, said the provision in the Sherman Antitrust Act authorizing punitive damages of three times actual damages is “offensive and contrary to our principles.”

—Wall Street Journal, Nov. 1, 1979

They failed to disobey the Energy Department The Energy Department is preparing to charge several major oil companies with failing to allocate gasoline properly during this year’s gasoline shortage.


The cruelest tax Nobody talks much about it, but the past several years’ inflation has provided a crucial element of the financial rescue of New York City.


The Taxbelt Contrary to the widespread impression of a “Sunbelt” bias in the distribution of federal money, federal aid for the region rose steadily during this period [the 10 years after: 1967]. After several years of posturing by northeastern officials, the General Accounting Office in 1977 finally made an analysis that confirmed the findings of Warren Brookes of the Boston Herald that the Northeast got back $1.06 for every tax dollar it sent to the federal government.

—Harper’s, November 1979