A Misguided and Harmful View of Trade Deficits

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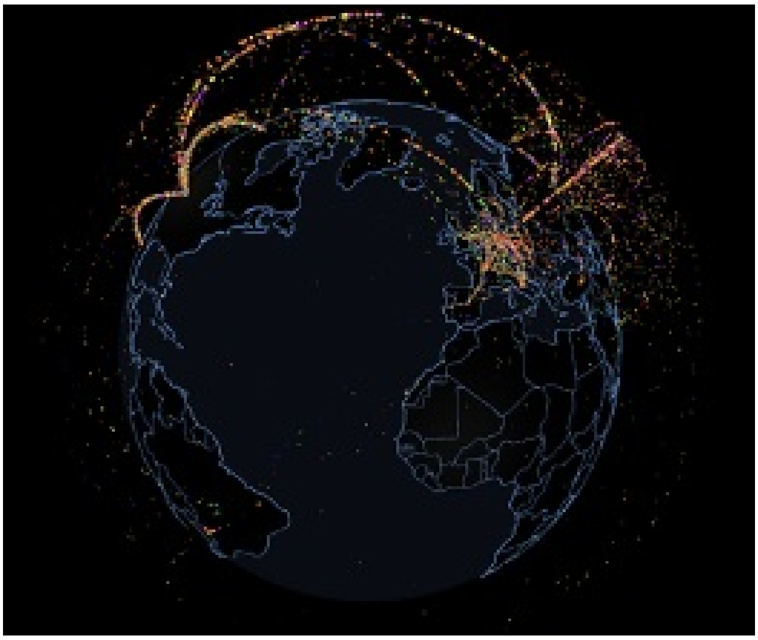
by Laurence B. Siegel

President Trump, like many others along the political spectrum, has derided the persistent U.S. trade deficit – particularly with China – as a waste of capital leaving our country. The view that the U.S. would benefit by correcting this imbalance is taken up in a new book, with a message that should concern all financial market participants.

Trade Wars are Class Wars, by Matthew Klein and Michael Pettis, is well researched. Its main premise, that trade "wars" are instigated by politicians who are trying to please constituents who believe they are getting a raw deal in life, is correct.[1] And the book contains a great deal of valuable descriptive economics and political analysis. The granularity of their knowledge and the diligence of their work are impressive.

But *Trade Wars* is laden with logical inconsistencies and proposes remedies for the United States that will hurt rather than help: restricting foreign investment, lowering taxes, and increasing government spending. It is a recipe for impoverishment everywhere and greater inequality among countries if not within them.

We are broke enough already!



A visualization of international trade flows.
Each color represents a different category of goods.
Source

Investors and their advisors should be on guard against policy prescriptions that attempt to return the economy to an imagined golden age of high wages for labor and low returns to capital. First, investors are holders of capital. Second, lower returns could ultimately translate to lower, not higher, wages. But, much more importantly, those high wages were earned largely for labor that was physically difficult, repetitive, health-ruining, and soul-crushing; work has gotten much easier. And, even if this old-fashioned work is desirable to someone, it's not coming back at high wages. Those wages were earned under the quasi-monopolistic position in manufacturing that the United States briefly enjoyed after the destruction of World War II. We are competitors in a global economy whether we like it or not.

Trade Wars are Class Wars advocates such atavistic policies.

Perhaps unwittingly, Klein and Pettis have written a mercantilist book, one that says a country is rich in proportion to what it can export. The money thereby obtained can then be used to buy gold and silver (remember, this is an old idea) for the national treasury, enhancing the country's wealth. Capitalism, in contrast, states that a country is rich in proportion to the quantity of goods and services it can produce, both for use and for exchange; and that the stock of human, financial, social, and physical capital that makes such production possible – not *money*, such as gold and silver – is the proper wealth measure. This latter, capitalist approach has proven to be by far the better wealth creator.

This article is a book review and an essay on trade. To understand today's complicated world, it is necessary to go back to basics. Why does trade occur? Is it good or bad? If one starts from the presumption that trade is good for both sides of the transaction, are there unforeseen consequences that could make it bad for one or both of them? These are the questions that economists should ask, but often don't.

Hobson's choice

The authors write under the influence of a mostly forgotten English Liberal author, John Hobson (1858-1940), who in 1902 crafted a theory of imperialism in which …

> free enterprise capitalism had a negative impact on the majority of the population… [T]he financing of overseas empires drained money that was needed at home. It was invested abroad because of lower wages paid to the workers overseas made for higher profits and higher rates of return, compared to domestic wages…Exporting capital, he concluded, put a lid on the growth of domestic wages in the domestic standard of living.[2]

Hobson had a blinkered view of both economics and humanity. He sought to overturn Say's Law and other basics of economic analysis, keeping him out of the circle of professional economists. He thought the colonial peoples inferior, sharply criticized the Jews, and influenced Lenin (although he was not a Communist). Hobson is an odd choice for an intellectual forebear, and the oddball economics of Klein and Pettis' book reflects that choice. It is hard to tell whether the authors are on the Sanderian left, the Trumpian right, or some combination, but these radical positions have some ideas in common – an America-first enthusiasm that embraces both opposition to free trade and populism – so the confusion is understandable.

A neoclassical trade theory primer

The authors rely on the oft-repeated allegation that there are massive imbalances in the system of trade that need to be corrected. For example, the U.S. imports more than it exports while China does the opposite. This is supposed to be bad, as reflected in the phrase "unfavorable balance of trade," unfavorable, that is, to the United States. This perception is wrong. Let's go back to basics as promised.

Neoclassical economics teaches that voluntary international exchanges of goods for money, or services for money, do not create imbalances. This is because both parties, having agreed to the transaction, must believe they are getting a fair deal. Adam Smith:

> Nothing…can be more absurd than this whole doctrine of the balance of trade…upon which… almost all the… regulations of [international] commerce are founded. When two places trade with one another, this [absurd] doctrine supposes that, if the balance be even, neither of them either loses or gains; but if it leans in any degree to one side, that one of them loses and the other gains in proportion to its declension from the exact equilibrium.

Smith, who wrote in 1776, went on to explain in detail that both parties gain irrespective of the relative quantities of goods exported and goods imported. Much has changed since 1776, but basic arithmetic has not, and if both countries gain from each little transaction, when you add them up they have still both gained.

Thus it is possible for Ruritania to sell only kumquats, import everything else it consumes, and have a perfectly satisfactory outcome (unless, of course, there is a kumquat blight that ruins the crop – but this is just a teaching example, not reality).[3]

David Ricardo (1772-1823),
father of trade theory
Source

David Ricardo, a few decades after Smith, noted that trade should be, and under free conditions is, based on comparative advantage rather than absolute advantage. Thus, if Portugal makes both wine and wool more efficiently than England, but Portugal's advantage is greater in wine than in wool, then Portugal should specialize in wine and England in wool, and trade with each other to achieve maximum prosperity (that is, maximum production of both goods). This principle is the basis for all trade theory, including major modifications made in more recent times – but Klein and Pettis, while paying lip service to Ricardian principles, show that they do not understand them. I will get to this later.

Many discussions of trade by non-economists, and some by economists, ignore Smith's and Ricardo's principles and make the mercantilist assumption, against which Smith was campaigning 244 years ago, that exporting is better than importing (that is, selling is better than buying). But selling and buying are, of course, two sides of the same coin – nobody sells anything without a buyer, and vice versa – and neither side of the trade is *better* than the other. Each of us sells something and buys many things. Mercantilism, which denies the beneficial character of that system when it applies to international transactions, is simply wrong and supports trade policies that increase poverty and discourage innovation.

Milton Friedman commented decades ago that many of the arguments against trade deficits ("imbalances") are veiled pleas by rent-seekers for protection of domestic industries that otherwise can't compete.[4] He was right.

Trade *finance* makes the story more complicated

In this little story of kumquats and British intellectuals, I've left out all the complicated parts. These include money (the "oil" that makes the trade practical), borrowing, the role of governments that control the money supply and the amount of sovereign debt, and a complex global supply chain in which components of final goods come from all over the place as does the money to pay for them. Moreover, there is the possibility that some countries may not "play fair," say by subsidizing the goods they hope to export.

These complications make neoclassical economics merely the foundation of, rather than the last word on, modern trade theory. Skilled economists such as Eli Heckscher (1919), his student Bertil Ohlin (1933), and the "good" Paul Krugman[5] have added much to our understanding of trade and of trade finance. The authors' worries about debt, capital flows, and consumption inequality have some validity. But their remedy seeks to *increase* the national debt of the U.S. – the opposite of what we need in this time of multiple catastrophes – and would decrease inequality, if at all, only by turning the clock back to a time that was poorer for almost everyone.

More likely, as I suggested at the outset, attempts to decrease inequality*within* a country would increase inequality *among* countries, sharpening the divide between the rich and poor worlds and reversing the remarkable progress made in developing economies in the last 40 years. Such a result would also intensify geopolitical tensions and cost the United States "soft power" in its complex relations with other states.

Ricardo redux

The authors' most glaring misunderstanding of Ricardo is that "[his] argument [about comparative advantage] made sense only under…primitive conditions" in which "travel was dangerous and wars were common": punishingly high transportation and transaction costs. In fact, Ricardo's theory is exactly correct only in a hypothetical world of *costless* and *frictionless* trade, the exact opposite of primitive conditions. And, echoing John Hobson, the authors rather tastelessly describe Ricardo as "a Jewish financier who became so wealthy after betting correctly on the outcome of the Battle of Waterloo that he was able to buy a seat in Parliament." (Maybe I shouldn't be so sensitive, but the authors describe Adam Smith, a

Presbyterian, in much more glowing terms.)

Then, a few pages later, Klein and Pettis reverse themselves and say that trade between Canada and Michigan is much more valuable than trade between Canada and China because the first pair are only a few minutes' drive apart. This is exactly what Ricardo's trade theory predicts. The authors are confused on basic principles.

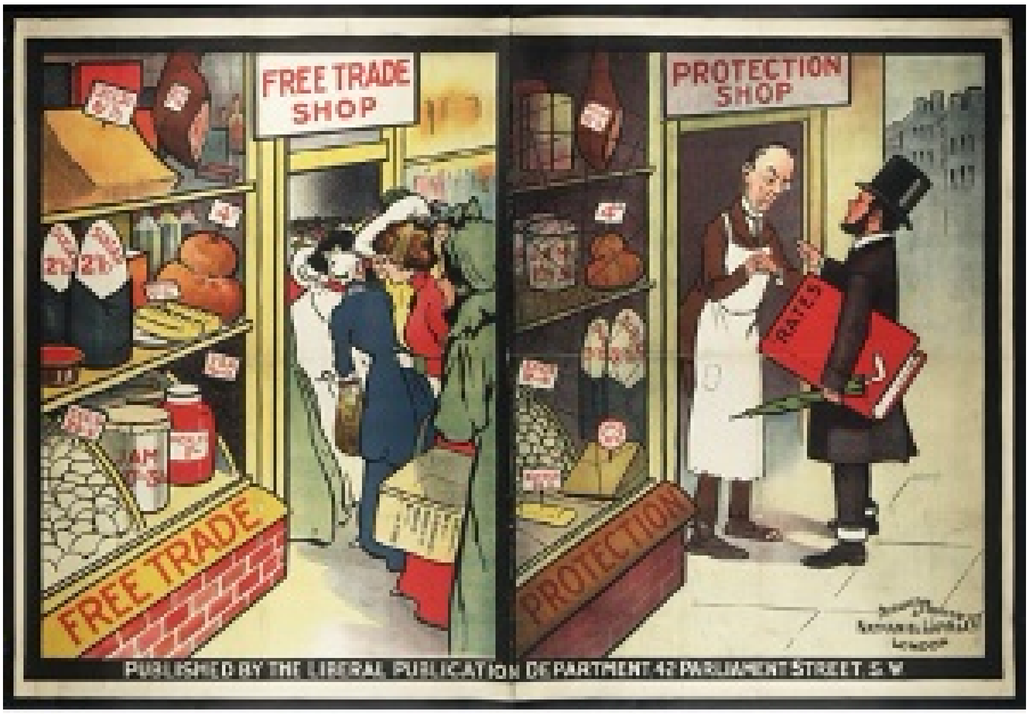
Minsky misconstrued

Klein and Pettis' classification of financing schemes closely parallels that of the late Hyman Minsky, whose work I mostly praised in this article in 2016. Minsky spoke of hedge finance, speculative finance, and Ponzi finance. Each is riskier and less sensible than the one before it. Applying similar thoughts to international transactions, Klein and Pettis come up with the following:

> *Trade finance*: "[T]he financial transactions are drive by relative production and transportation costs. Moreover, because the spread of international trade will be driven by Ricardian principles of comparative advantage" [Ricardo is a good guy again], "the overall global economy unambiguously benefits…"
>
> *Investment finance*: "International financial flows can consist primarily of*rational* [their italics] seeking out the most productive opportunities around the world. In this scenario, finance is likely to flow from rich, mature economies to rapidly growing developing economies… This roughly describes trade for much of the nineteenth century."

The nineteenth century? Many people would call it a period of exploitation, but if you don't care about democracy and self-rule, the colonies came out ahead. At any rate, the authors say that "the overall global economy unambiguously benefits… because it helps less productive economies to converge with societies at the technological frontier. It's hard to argue with that. We've seen this in operation over and over, not just in the nineteenth century and not just with colonies.

Moreover, while we may think of the nineteenth century as a time of unfettered capitalism and free trade, that was true only of the first part of the century. In the latter part, "protectionism" in the form of tariffs and other barriers to trade became popular, even among liberals such as Abraham Lincoln. I could have titled this article, "The Nineteenth Century Called and Wants its Trade Policy Back." British Liberals[6] defended free trade for another half-century or more before acquiescing to new forms of mercantilism (see the poster).



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> *Speculative finance*. This is where Klein and Pettis get in logical trouble. It is easy to lampoon modern financial markets, with overpaid "young white men baying for money on the bond market," to quote the very funny Tom Wolfe.[7] (Klein and Pettis could have benefited from a little levity.) But the radical deregulation of financial markets around 1980 corresponds very closely in time with the sustained take-off of the less developed world into its current condition of modest prosperity. The world per capita GDP of $18,000, expressed in purchasing-power parity terms, equals the per capita GDP of the United States – then the richest country in the world – in 1949, within the memory of many

people now living. This is an incredible accomplishment that lowered the World Bank's estimate of the percentage of the world population living in extreme poverty from 40% in 1980 to 9% today. Nothing like this has ever happened before.

I can't prove that the wild race of money, securities, and derivatives across the globe since 1980*caused* the economic improvement. There were many other factors, including political liberalization in China, Russia, Eastern Europe, and India as well as a gradual abandonment of socialist dogma in much of Africa. But, while synchrony does not imply causation, it sure is a hint. I don't want to reverse the experiment, tightly regulate global financial markets, and see whether extreme poverty returns in half the world!

Case study: What happened in Germany?

The authors discuss China, Germany, and the U.S. in detail. I'll focus on their account of the German economy in the wake of the transition from two separate states, one capitalist and one Communist, to the unified Germany we know today. They blame a "class war" in Germany (documented with vivid diagrams of rising inequality) for Germany's supposedly destructive trade *surplus*, caused by Germans spending much less than they earn. They blame the supposedly destructive trade *deficit* of the United States, caused by Americans spending more than they earn, on the same class war. It is hard to see how this is logical. It is also hard to see why what the authors call "underconsumption," is a bad thing.[8] Most of us call it "living within your means."

Along the path from two countries to one, according to the authors, Germany became known as the "sick man of Europe" (a rotating designation that has historically included Britain, Italy, the Ottoman Empire, and so forth). The sickness was primarily caused by the costly transfer of resources from West to East in an attempt to equalize economic conditions in the newly enlarged Federal Republic.

The central thesis of the book is that class wars cause trade wars by inducing politicians to impose trade restrictions in an attempt to reduce domestic inequality. The authors assert, using a variety of measures, that the class war in Germany is evident from growth in corporate profits, stagnation in wages, and a variety of more esoteric measures such as median wealth (on which they say Germany does worse than Spain and is on par with Greece and Poland!).

But, looking at widely available data, the evidence for a class war in Germany is skimpy. The Gini coefficient, a commonly used measure of economic inequality, was 0.29 in 2017, right at the European Union median. For comparison, the U.S. was 0.38 and the U.K. was 0.36 in the same year. And anyone who knows Germany recognizes that the extremes of wealth and poverty there are much more muted than in the U.S. and U.K. Germany's Gini index is, in fact, lower than that of France or Ireland.[9] Some class war.

But something real did happen to make Germany stand out. Its Gini index rose more quickly between the mid-1980s and today than in practically any other country. In the mid-1980s, West Germany was one of the most egalitarian countries in the world.

The change happened, of course, because in the mid-1980s all the poor Germans lived in a different country – East Germany. (I exaggerate only a little.) Of course Germany's Gini index rose when it absorbed a much poorer country! And that is probably a sufficient explanation for the observed increase in inequality. But the authors instead attribute it to "national income shift[ing] from workers to the owners of capital." And, as examples of the winning class, the authors name "shareholders, creditors, and property owners."

This claim of the authors does not square with facts on the ground. In Germany, most landlords are smallholders: "A third of all German homeowners own multiple rental properties that they rent out to others," they write. This is a recipe for relative equality, not the amassing of great fortunes. German savings portfolios are bond-heavy and equity-light. And the *mittelstand*, the cloud of small- to medium-sized and mostly family-owned businesses that supplies larger companies with parts and services, is the cornerstone of the German economy; it makes a lot of people moderately wealthy but very few absurdly so. Inequality may have increased recently but it is still very modest compared to that in many other rich countries.

A very non-Marxian class war

Actually, the winning class, almost everywhere and certainly not just in Germany, is the group of people called "professional, technical, and managerial" by the U.S. Census Bureau.

The class "war" that has stirred dissatisfaction regarding trade and other matters, then, is not a conflict between labor and capital but between two kinds of workers – that is, owners of two kinds of *human* capital. One class consists of those who work primarily with their minds; the other, pretty much everybody else. Much more dramatic increases in inequality occurred in China and the United States than in Germany, due to extremely fast economic growth in China and a rearrangement of rewards between low- and high-skilled labor in the U.S. Note that "trade surplus" and "trade deficit" countries have had this shared experience; it is not a determining factor in trade patterns.

In fact, entrepreneurs who amass great fortunes are essentially selling their very high-priced labor, not collecting returns on capital. And most people admire them. What's really galling is not Bill Gates's or Jeff Bezos's fortune, but the fact that the guy who sat next to you in high school is, 20 years later, making $500,000 a year in a finance or technology job when you're making $50,000. That spread would have been narrower one or two generations ago.

Reversing this trend will not be easy. Vocational education and a reduction of the social stigma related to non-intellectual labor are much discussed.[10] The solution to this challenge, if there is one, is outside the scope of this book and my review of it.

Conclusion and advice for investors

Investors and their advisors should not be fooled by arguments, including those about trade, that favor one side of a transaction over another. All investors are either global investors or should be; and even those whose only equity risk exposure is the S&P 500 earn between 40% and 50% of their profits from non-U.S. sources. Any resolution to the so-called class war that avoids or lessens trade tensions and encourages free trade should be good for investors, as long as that resolution does not destroy incentives or tax income and wealth too onerously.

But the authors' remedies do not fit these criteria and should not be pursued. Their remedies are more likely to close off trade further than to liberate it, because they will reduce prosperity, intensifying demands for even more regulation of trade and of other economic activity. The only way to have free trade is to say, "you are free to trade."

In the last 70 years, in fact mostly in the last 40, we've opened a door that has not previously been opened in the history of the world. The door offers the opportunity, at least in the long run, of modest prosperity for almost everyone no matter where they're born. The explosion of wealth in developing countries in the last 40 years, most visible among the poorest of their citizens, is the direct result of trade and specialization, what Adam Smith regarded as the keys to betterment. The authors of *Trade Wars are Class Wars* want to keep the door open but the remedies they favor would cause it to be closed tighter. And, once you've opened that door, closing it would be, in Shakespeare's words, "the most unkindest cut of all."

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[1] I put scare quotes around "war" in this context because "the moral equivalent of war is hell," as Alexander Meiklejohn (1872-1964), president of Amherst College, famously said (Association of American Colleges Bulletin, Volume 9, no. 1 [February 1923]). Whatever you think of trade wars and class wars, they are not comparable to real wars in any moral universe that I'm aware of.

[2] The quote is from https://en.wikipedia.org/wiki/Imperialism, accessed on June 3, 2020. See also Hobson, John A. 1902. *Imperialism: A Study*, New York: James Pott & Co.; free on Google Books at https://www.google.com/books/edition/Imperialism/djwQAQAAMAAJ.

[3] Marxists (Groucho Marxists, that is) will recognize Ruritania as familiar territory, although Anthony Hope, the author of *The Prisoner of Zenda*, invented it a couple of generations earlier.

[4] Friedman, Milton, and Rose Friedman. 1980. *Free to Choose*.

[5] Please see my article distinguishing the good from the bad Paul Krugman The good one made seminal contributions to trade theory and economic geography, for which he won a Nobel Prize. The bad one is a name-calling, partisan crank who attributes evil motives to people with whom he disagrees. Somehow the two Krugmans coexist in the same body.

[6] Upper case because it was the name of a political party in Britain (since merged into the Liberal Democrats).

[7] *The Bonfire of the Vanities* (1987).

[8] Underconsumption, as an explanation for poor economic performance, is a mostly discredited idea associated with mercantilist economic theory as set forth by De Laffimas (1598) and picked by 19th century British economists, among them John Hobson (discussed earlier), who rejected the classical framework of Smith and Ricardo. The idea was picked up by Marx and later by Keynes, but both were ambivalent toward it; Klein and Pettis rely heavily on it. It lives on, in a modified form, in Keynesian attempts to revive a stagnant economy by stimulating consumer spending. See De Laffimas, Barthélemy. 1598. "Les Trésors et richesses pour mettre l'Estat en splendeur et monstrer au vray la ruine des François par le trafic et négoce des estrangers."

[9] See https://www.oecd.org/els/soc/cope-divide-europe-2017-background-report.pdf for the Gini data.

[10] See, for example, Lerman, Robert E. 2019. "Building a Robust Apprenticeship System in the United States: Why and How," in Adler, David E., and Laurence B. Siegel, editors, *The Productivity Puzzle: Restoring Economic Dynamism,* Charlottesville, VA: CFA Institute Research Foundation, https://www.cfainstitute.org/-/media/documents/book/rf-publication/2019/the-productivity-puzzle.ashx, pp. 197-219.

