

## The Trade Deficit Reflects U.S. Competitiveness

*Which car is more American: a Honda Civic sedan made in Ohio or a Chrysler Town & Country minivan made in Ontario?*

A car begins with a design. An engineer imagines what it should look like and how all the pieces should fit together. Someone else mines the iron ore that will become the steel; another person mines the platinum that will go into the catalytic converter; and still another person slaughters the cow for the leather interior. The manufacturer brings all the pieces together for assembly according to the design. The car's buyer, of course, has to fill it up with gas before going anywhere. Every step is important, but some add more value than others. The slaughterhouse worker, for example, needs few skills beyond strength, and the leather that his work generates isn't integral to the finished product; it could be replaced by cloth or vinyl. The engineer, on the other hand, is key because without her basic design, there is no car. If she develops a great new body shape or an engine that uses less gasoline, then she can add a lot of value to the finished product. She can directly influence how much the car costs and how well it sells.

Although different processes add different amounts of value, the system of accounting for international trade looks at the movement of goods and services over national borders and has no appreciation for ownership. Setting aside the huge problems that the General Motors Corporation (GM) has experienced in its U.S. operations—brought on by bad choices in product design and labor decisions, etc., but that's

another issue—GM’s basic business strategy perfectly exemplifies how a U.S. multinational company’s structure interacts with the trade deficit and the dollar. When GM makes parts in the United States, sends them to Canada to put into Chevy Impalas, and then ships those Impalas back to the United States for sale, the company has engaged in two international transactions: it exported the parts and imported the car. The parts cost less than the finished car, so GM’s imports exceeded its exports, adding to the U.S. trade deficit; yet all the transactions took place within the virtual walls of the same U.S. corporation. Essentially, GM is moving goods from one side of the corporate factory to the other; it’s just that the forty-ninth parallel weaves in and out across the floor. (Amazingly, the movement of goods and services within the same company accounts for half the U.S. trade deficit.)

We’ve all heard the worries: America has turned its global supremacy over to the Chinese. Our jobs are going to China, and the Chinese are practically buying the U.S. government because they buy all our Treasury bonds. The main piece of evidence cited for this is the U.S. trade deficit. In 2008, the United States recorded an average monthly trade deficit of slightly more than \$57 billion. It shows how miserable the United States has become. As Americans consume more than they produce, or invest more than they save, China is quickly moving into ascendancy.

Right?

Wrong. But that’s the way too many people think of foreign trade. Too often the focus is strictly on this number called a *deficit*. It is simply understood that deficits are bad, and what’s happening behind the numbers is frequently left unexamined. Americans produce ideas, and ideas can generate a spectacular amount of money. Microsoft, for example, doesn’t produce much that anyone can touch or feel, but its software has changed the way that we all live, work, and play. How do we account for that? Software, drug patents, product designs, secret formulas, and desirable brand names generate huge profits from all over the world for American companies. When those companies move goods and services between their own offices, it can contribute to the U.S. trade deficit.

Trade accounting is misunderstood. It was designed for a world that no longer exists, one in which dominant nations exported and weak ones imported. Now, goods, services, and ideas flow across borders, as does investment capital. Companies can parcel out business operations not only around the globe but also within the same corporate entity.

The trade deficit is large, but it is not a sign of national weakness, nor is it a twin of a budget deficit as is often portrayed. American workers and American companies are still the envy of the world, even if it's not apparent looking at the trade deficit.

## How Trade Accounting Works

At its simplest level, the trade deficit is the value of goods and services exported minus the value of goods and services imported. However, the accounting for it gets complicated. How do we value goods made and sold overseas under patents and trademarks developed in the United States? What if the basic assembly is done overseas but the finishing work is done here? What if the parts are manufactured in three different countries? What if a U.S. retailer asks a clothing manufacturer to start shipping goods on hangers instead of folded in boxes? How much value do those hangers add?

To keep track of the funds that cross borders, nations rely on a system of accounting called the *balance of payments* (BOP).

In each nation, a central agency (in the United States, the Department of Commerce's Bureau of Economic Analysis) collects data, adds up the value of all imports that come into the country during a set time period, and then compares the total to the value of all items exported. For the purposes of the argument here, we will leave aside issues relating to the bias of the data collection. There is a vested interest in documenting imports, since the government often collects a duty or tax. There are also security reasons for documenting imports. Exports are a different story. The full value of U.S. exports may not be fully captured in the official data.

The transactions are separated into three accounts. The *goods and services trade account* only includes imports and exports. The *current account* includes the goods and services trade account along with worker remittances, tourism, and transfer payments (i.e., foreign aid, charity, gifts to relatives overseas, as well as interest and profits from capital investments, royalties, and licensing fees). The *capital and financial account* includes investments made by individuals, corporations, and governments.

A country that exports more goods and services than it imports will have a trade surplus. A country that imports more than it exports will have a trade deficit—and the United States has had a trade deficit for more than thirty years. Intuitively, we know that surpluses are good and deficits are bad, but international trade is far more complicated than

that. A trade surplus doesn't mean that a nation is getting ahead, and a deficit doesn't mean that it is falling behind. What matters more are the reasons for a deficit or surplus. Is a country importing because its service-industry workers are prosperous? Or is it importing because its economic base is so primitive that there are no goods to export and imports arrive almost entirely in the form of charity?

*Table 1.1* illustrates the international trade transactions of the United States from 2006 to 2008, showing how Americans do business around the world.<sup>1</sup> The trade deficit is calculated in the current account by subtracting imports from exports (line 1 – line 2 = line 3).

**TABLE 1.1** U.S. Balance of Payments (2006–2008 Data) in Millions of \$

Line	(Credits +, debits -)	2006 year	2007 year	2008 1Q
<b>Trade account</b>				
1	Exports of goods	1,023,109	1,148,481	317,813
2	Imports of goods	-1,861,380	-1,967,853	-528,845
3	<b>Trade account</b>	<b>-838,271</b>	<b>-819,372</b>	<b>-211,032</b>
<b>Current account</b>				
4	Income receipts on U.S.-owned assets abroad	682,270	814,807	198,700
5	Other private services	189,050	223,483	60,850
6	Transfers under U.S. military agency sales contracts	17,430	16,052	4,068
7	Tourism dollars received	154,079	173,884	48,958
8	Royalties and license fees received	72,191	82,614	22,267
9	Compensation received for U.S. employees of foreign companies	2,880	2,972	757
10	U.S. government miscellaneous services	1,155	1,212	314
11	Total payments from foreign sources	1,119,055	1,315,024	335,914
12	Income payments to foreign-owned assets in the U.S.	-618,467	-726,031	-167,125
13	Other private services	-125,221	-144,375	-38,032
14	Direct defense expenditures	-31,032	-32,820	-8,783
15	Tourism dollars paid	-164,867	-171,703	-46,239
16	Royalties and license fees paid	-23,777	-25,048	-6,209
17	Compensation paid to foreign employees of U.S. companies	-9,489	-9,999	-2,561
18	U.S. government miscellaneous services	-4,021	-4,184	-1,082
19	Total payments to foreign sources	-976,874	-1,114,160	-270,031
20	<b>Net payments from foreign sources</b>	<b>142,181</b>	<b>200,864</b>	<b>65,883</b>

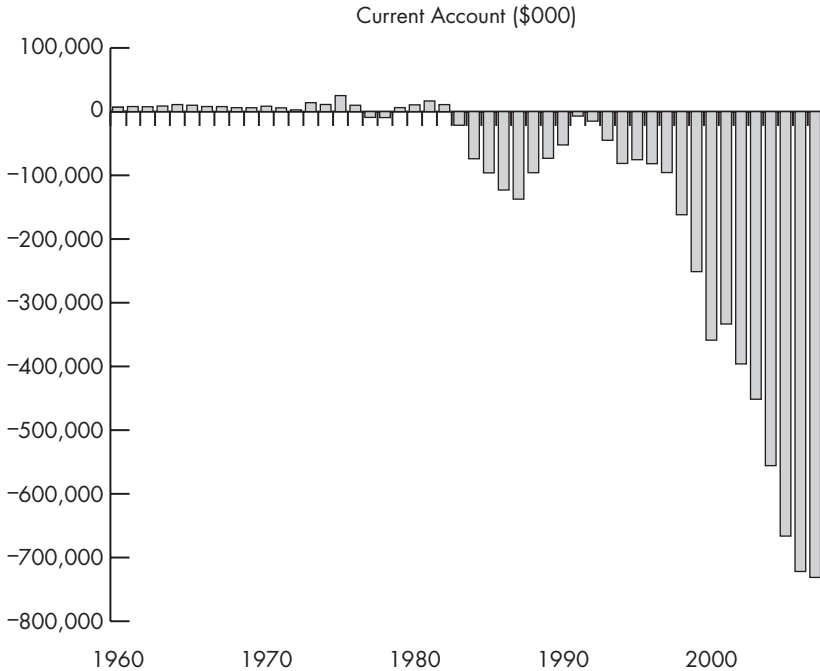
(continued)

Line	(Credits +, debits -)	2006 year	2007 year	2008 1Q
21	Transfer payments	-92,027	-112,705	-31,227
22	<b>Total current account</b>	<b>-788,117</b>	<b>-731,213</b>	<b>-176,376</b>
<b>Capital and financial account</b>				
23	<b>Capital account transactions, net</b>	<b>-3,880</b>	<b>-1,843</b>	<b>-597</b>
24	U.S. official reserve assets	2,374	-122	-276
25	U.S. government assets, other than official reserve assets	5,346	-22,273	3,346
26	Total foreign assets held by the U.S. government	7,720	-22,395	3,070
27	Direct investment by Americans in foreign assets	-241,244	-333,271	-85,608
28	Foreign securities held by Americans	-365,204	-288,731	-38,826
29	U.S. assets by unaffiliated foreigners reported by U.S. nonbanking concerns	-164,597	-706	53,644
30	U.S. assets reported by U.S. banks, not included elsewhere	-488,424	-644,751	-218,907
31	Total foreign investment by the U.S. private sector	-1,259,469	-1,267,459	-289,697
32	Total foreign investment by Americans	-1,251,749	-1,289,854	-286,627
33	Foreign government holdings of U.S. government securities	453,582	344,367	142,568
34	Foreign government holdings of other U.S. assets	34,357	66,691	30,933
35	Total U.S. assets held by foreign governments	487,939	411,058	173,501
36	Direct investment by foreigners in U.S. assets	241,961	237,542	46,627
37	U.S. government securities held by foreigners	-58,204	156,825	68,932
38	Other U.S. securities held by foreigners	683,363	573,850	-20,115
39	U.S. currency held by foreigners	2,227	-10,675	-914
40	U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns	242,727	156,290	57,185
41	U.S. liabilities reported by U.S. banks, not included elsewhere	461,100	532,813	85,746
42	Total U.S. investment by the foreign private sector	1,573,174	1,646,645	237,461
43	Total U.S. investment by foreigners	2,061,113	2,057,703	410,962
44	<b>Financial account transactions, net</b>	<b>809,364</b>	<b>767,849</b>	<b>124,335</b>
45	Financial derivatives, net	29,710	6,496	0
46	<b>Total capital and financial account balance</b>	<b>835,194</b>	<b>772,502</b>	<b>123,738</b>
47	<b>Statistical discrepancy</b>	<b>-47,078</b>	<b>-41,287</b>	<b>52,638</b>

Source: U.S. Department of Commerce.

Although the current account's traditional components are raw materials and finished goods, services are included, although the total value may be more difficult to track. Goods go through customs; at points of entry, they are tallied and inspected. But services? When a British family flies to Orlando for vacation, it's as though American companies are exporting vacation services. But just exactly how much money did the family spend on hotel rooms, amusement park tickets, food, transportation, and incidental services? Did anyone tip the hotel maid? Many of these numbers are estimates that may throw off the values in the current account (see *Figure 1.1*).

The total current account (Table 1.1, line 22) includes money as well as goods. These payments include income from U.S. businesses overseas, e.g., the profits that accrue to McDonald's from its global restaurant operations (Table 1.1, line 4). The current account includes



**FIGURE 1.1** Americans Have Imported More than They Have Exported Every Year Since 1983

Source: U.S. Bureau of Economic Analysis. "U.S. International Transactions: First Quarter 2008," June 17, 2008.

dividends that American investors receive from their investments in international stocks (Table 1.1, line 4), and it includes compensation earned by American workers employed by foreign companies (Table 1.1, line 17). It shows how the money flows to and from Americans, but it doesn't always capture the total economic value of what is being transferred. Does importing raw materials and exporting finished goods leave more value in the United States than importing accounting services and exporting software? Than importing profits and exporting brand names? Than importing actresses and exporting movies?

The capital account (Table 1.1, line 23) includes net transactions in nonfinancial assets, usually real estate or businesses. Capital imports are as controversial as current account imports. They include money that comes into the country when a German or Japanese company acquires a business or builds a factory here, which sometimes generates concerns about the increased role of foreign businesses in this country.

Capital can be exported, and Americans export capital all the time. McDonald's, Coca-Cola, and Procter & Gamble became household brands worldwide by exporting capital. Companies do it when they buy an international subsidiary or open a sales office overseas.

General Motors, which has been hobbled by its U.S. operations, sold more than one million cars in China in 2007, giving it nearly one-eighth of one of the fastest-growing auto markets in the world and making it the largest foreign automaker in the country.<sup>2</sup> None of those cars were made in the United States; most were assembled in China. That GM plant in Shanghai? It represents an export of capital that began in the early part of the twentieth century. And it's not just GM. Individuals export capital when they buy vacation condominiums in Mexico. In the first quarter of 2008, Americans exported \$597 billion in capital.<sup>3</sup>

The balance of payments is set up as an identity equation: the current account (Table 1.1, line 22) equals the capital account (Table 1.1, line 23) plus the financial account services (Table 1.1, line 44). The financial account has two components: private assets (Table 1.1, lines 31 and 42) and official assets (Table 1.1, lines 26 and 35). Private assets are the financial investments in stocks and bonds made by individuals and businesses. Along with imports and exports of goods, services, and corporate capital, a lot of money flows over national boundaries. When the BOP was invented, it would have been unimaginable that an average American could buy software delivered over the Internet by

an Indian company, let alone purchase shares in companies traded on the Hong Kong exchange simply by clicking on a button. But that's the reality. The Internet, standardized financial contracts, and an awareness of how many great investment opportunities there are around the world have whetted the American appetite for international investing. It's a simple matter to buy a global mutual fund, a developing market exchange-traded fund, or a stock of a company based somewhere else. These transactions fall into the financial account (Table 1.1, line 44).

By definition, the balance of payments has to balance. It includes so many transactions, however, many of which are estimates, that it never equals exactly zero. That's why it includes a plug factor, a *statistical discrepancy* figure (Table 1.1, line 47) that forces the calculation to balance. It's nothing more than an offset to the imbalance that has been created by the estimates themselves. However, it does not balance over several quarters even though in theory it should. (Some people think this might be a measure of smuggling, drug trades, and terrorist activities that aren't reported on customs forms or income tax filings.) It is often statistically significant. In the first quarter of 2008, for example, the statistical discrepancy was at \$51.6 billion on a \$176.4 billion estimated current account deficit.<sup>4</sup>

And that is the balance of payments.

## What Do All Those Numbers Mean?

The BOP figure, which the United States publishes quarterly, was established during an era in which currencies did not float freely and capital mobility was limited. Under the Bretton Woods agreement of 1944, the exchange rate for the dollar was fixed to the price of gold and the rest of the currencies were pegged to the dollar and a fixed exchange rate. Government officials had to buy or sell securities and transferred gold to maintain the respective fixed exchange rates.

Nations that peg their currencies to other currencies, such as Thailand did before 1997 and Saudi Arabia does today in 2009, still have to do that. When Thailand suffered inflation in the mid-1990s because of a real estate price bubble, the government was forced to buy more reserves to prop up its currency. By 1997, the Thai government ran out of money and was forced to accept an international bailout organized by the International Monetary Fund. The entire process could have been avoided if Thailand had allowed its currency to float in the open market, which it has done more or less since the Asian financial crisis of 1997–1998.



Countries, including the United States, keep official reserves. Most commonly, the reserves are held in the form of gold, foreign currency, and Special Drawing Rights with the International Monetary Fund. Reserves are accumulated when a government requires converting export earnings from the nation's domestic firms through various other operations meant to insulate an economy from short-term capital flows and through intervention in the foreign exchange market.

To fund its current account deficit, the United States must be a net importer of capital. If the private sector is incapable or unwilling, resulting in downward pressure on the dollar at times and upward pressure on other currencies, foreign central banks often step into the breach. They buy U.S. dollars and sell their own currency. How willing countries are to tolerate volatile currencies (which is how many experience what the G7 euphemistically calls "flexible" exchange rates) depends on numerous factors, including: the strength of domestic financial institutions, sensitivity of exports and inflation to currency appreciation and depreciation, and the significance of the export sector to the overall economy.

That the balance of payments is calculated on a flow basis, not a stock basis, is also a source of confusion. This means that the numbers represent changes in value, not absolute amounts of value. The BOP doesn't consider inflation. It can't take into account how General Motors has steadily increased the value of its business in China by entering the country eighty years ago, writing off that investment after the Communists took power and then recovering part of it through its interest in joint ventures begun in 1999 when the Chinese economy took off. That's one reason that U.S. investments overseas tend to look smaller than foreign investments in the United States. Just about everything everywhere costs more in 2008, when international acquirers went on a buying spree in the United States, than it cost in the 1950s, 1960s, and 1970s, when U.S. companies were getting established overseas. Economists often use historic prices for valuing direct investment. Changes in the value of those operations, whether due to changes in overall prices or ongoing investment and expertise, are not marked to market until they are realized when they are sold. As that overseas business grows, it can generate funds to continue its expansion, so no more capital is exported, but the profits aren't necessarily returned here right away. GM, for all its woes in the United States, is reinvesting its Chinese profits in China. Traditional accounting undervalues the benefits that

accrue over time to a global corporation based in the United States and investing overseas for the long haul.

Trade brings business into the United States. When goods are imported, someone has to get them off ships and across the country into consumers' hands. Because the United States has 300 million consumers spread out over 3.8 million square miles, storage, transportation, and marketing costs can end up being 30 percent to 50 percent of the cost of goods sold. As a proportion of the sale price, these other locally incurred costs appear to be greater in the United States than elsewhere and help explain why trade flows are not as sensitive to the vagaries of the dollar in the foreign exchange market. Those costs also represent revenues for some American companies and earnings stream for some American workers.

## **The Old-Fashioned World of Trade Accounting**

Trade accounting reflects a very different era. In the eighteenth and nineteenth centuries, economists approached the world mechanically. Classical economists such as Adam Smith (eighteenth century) and David Ricardo (nineteenth century) thought that debits had to equal credits, gains had to equal losses, and exports had to equal imports or the world would fall into chaos. But over time, it's become clear that imbalances create opportunities. Unlike the classical view of the world, modernity embraces imbalances. Chaos theory and work with large systems seem to emphasize the problems with that old-fashioned approach. Looking only at the sum of the world's imports and exports overlooked other ways in which people did business with each other.

A modern economy is full of strains and stresses that form as businesses succeed and fail. Balance is the exception to the rule. Growth, which is the rule, means things are out of balance. When an economy expands, supply and (effective) demand are out of balance. That's good. Capitalism is not a calm pond; it is a tumultuous ocean.

Why would we expect trade to be different? We might because modern trade accounting is based on the old-fashioned notion that trade involves only raw materials and finished goods. It evolved in the 1930s by the Bank for International Settlements to manage Germany's reparations for World War I and to promote monetary stability. Even though the Great Depression raged, the United States had strong industry relative to the rest of the world, which was either underdeveloped or damaged by

war. The United States almost always exported more than it imported; it showed a trade surplus under the BOP for decades. It became normal to think of a trade surplus as the way to measure America's strength relative to the rest of the world.

But then the world changed. Now, Pakistanis buy MP3 players designed in the United States and manufactured in China. They load those machines with content produced in the United States, or Ireland, or Mexico and downloaded from Web sites hosted in the United States, using debit cards branded in the United States but offered through a bank once based in the Netherlands, now owned by a bank in Scotland.

In decades past, when American companies imported oil, then pressed vinyl records, put them in cardboard sleeves, and sent them overseas, trade accounting was much simpler. But now that content is purchased electronically and paid for electronically, the old accounting system breaks down.

Although Apple Computer makes a hefty profit selling iPods, each one sold increases the U.S. trade deficit by \$150.<sup>5</sup> Yet, the iPod sells for about twice its cost of goods, which means that \$150 accrues in profit to an American company for each iPod sold. That doesn't get factored into the trade deficit. Who would argue that America would be a more competitive nation if Apple had never developed the iPod? Would it be better if a Chinese company had invented the iPod and manufactured it here? How about if a Chinese company had invented the iPod and sold it only in China?

The BOP was established when labor and manufacturing formed the basis of the U.S. economy. Americans are known for high-level skills, including design, technology, financial services, and generally getting things done. These often add more value than manufacturing. The balance of payments doesn't fully account for that.

Traditional trade accounting wasn't designed for the activities of multinational corporations that don't care about borders—unless, of course, sending goods across a border means paying a tax. Modern companies want to sell to everyone everywhere, whether they are in Shanghai or Chicago. The activities of multinational corporations are tracked using an accounting system designed for a world where only some nations could do sophisticated manufacturing. In the modern era, manufacturing can be done almost anywhere. And now so can many white-collar jobs that people once thought could only be done at home—thanks to technologies

that have expanded the span of command, control, and communication functions. Employers can share ideas with their employees and monitor performance without ever getting on an airplane. They can hire contractors with an assurance that the work will get done as well abroad as it would be at home. Accountants in India, customer-service representatives in the Philippines, and graphic designers in the United Kingdom can now serve American taxpayers, consumers, and businesses from their own countries, close to their own families, ensconced in their own cultures. None of this was possible two decades ago, let alone when the BOP was invented.

## Offshoring, Outsourcing, and Intrafirm Trade

The BOP understands international trade as involving two parties: a buyer and a seller. That's changed.

Businesses face long chains of processes between idea and customer: inventory, design, manufacture, sales, marketing, advertising, accounting, human resources, and office management, just to name a few. The modern business was not born in its current form, like Athena popping full grown from the head of Zeus. Initially, the same company that produced the goods did not do the marketing and sales, for example. A drive to control and lower costs encouraged companies to integrate functions. A company can own the raw materials, the transportation, the office building, and even the advertising. We call this *vertical integration*. If a company is not publicly held, it doesn't even have to hire an outside accounting firm. Yet almost all businesses find it distracting and costly to do everything; instead, employees concentrate their energy on what the firm does best and then create networks of suppliers and service providers to handle everything else. Managers coordinate these relationships rather than dream up new ways to arrange the internal processes.<sup>6</sup> That's outsourcing.

Some companies find that it makes sense to take in house functions that had once been outsourced. They may start simply by adding accounting, legal, and human resources departments, or they may add a lot of complexity by opening retail stores, acquiring manufacturers, hiring designers, and taking on other links in the chain between concept and customer. They might do this all over the world, too.

Outsourcing is often confused with offshoring, but they are not the same. Offshoring involves exporting a business function to another country. This can be done through outsourcing—hiring an outside

firm in another country to handle the work—or simply by acquiring or opening a facility in the new country and doing the work there. Of course, with so many global brands headquartered in the United States, America provides offshored and outsourced services on an enormous scale. Business operations all over the world rely on American branding, American technology, and American financial services.

Companies often outsource and offshore to save money, but they also do it to improve quality, get more flexibility, or gain local market experience. Managers have to decide if it makes more sense to build or to buy the capabilities that they need. Think about advertising. A business can create and place its own ads in-house. Maybe it can be done cheaply that way, relying on simple ideas and maybe the assistance of a clever employee or an occasional intern. But if those ads work, the company will grow larger and will want or need full-time people to create and place ads. However, it may be difficult for a manufacturing company to hire good advertising folks because it can't offer them the same career-development prospects, variety of work, or quirky office culture that an advertising agency can. The company will probably decide to outsource its advertising campaign to an agency that specializes in nothing but ads—even if it ends up costing more than hiring someone to do it internally.

Now imagine this company expands to another country. Does it make sense to keep shipping goods abroad and promoting them with the home advertising agency? Even if labor costs are higher, the company might find that opening a manufacturing facility and hiring a local advertising agency offer better returns on investment. In fact, having local operations may help the company generate much higher profits than if it relied on support from back home. Unfortunately, for getting a handle on global economic relations and competitiveness in the twenty-first-century, the BOP accounting system puts more value on costs than on profits, even though profits ultimately motivate economic activity and help American companies thrive domestically.

Outsourcing and offshoring can also give businesses and countries access to skills that may not be available locally. Politicians all over the world hire American campaign strategists who have perfected the art of winning elections. Where democracy—or negative campaigning—is new, it makes sense to bring in the U.S. experts. Even in Zimbabwe. Could the good folks drawing up the BOP have imagined a time when a corrupt African dictator would hire an American agency to help him win a rigged election?

## The Current Account and Economic Risk

Changing patterns of trade between and within corporations has produced large U.S. trade deficits. It is a source of anxiety, for sure, but it is misplaced. Yet the biggest risks to the world economy in general and the U.S. economy in particular are not the imbalances, but the attempts to fix them through protectionism, which often sacrifices growth and development. Most proposed cures seem worse than the supposed illness. If the United States was forced to run a balanced trade account, as some like Warren Buffett have proposed, it would likely translate into higher unemployment, lower wages, and lower living standards for most Americans and a broad swathe of the world.<sup>7</sup> In no way should the U.S. deficit be seen as an automatic sign of weakness.

In a world of capital market mobility, the price of financial assets adjusts quickly (perhaps too quickly). An imbalance may show up in the currency markets, or it may appear in asset markets as companies sell expensive assets to buy cheaper ones. An imbalance can and usually does come from a combination of price adjustments in both the currency and asset markets. A century ago, the imbalances were larger and more persistent because the gulf between the few industrialized nations and the many lesser-developed economies was huge and capital was not nearly as mobile. Technology and new financial instruments have now made it possible for world financial markets to cope with larger imbalances.

The underlying concern is that America will become a weaker nation if it is not self-reliant. As a share of GDP, U.S. imports and exports are smaller than many other advanced industrialized countries, but still many chafe under developments in the past third of a century that made for greater interdependence. America is richer, better, and stronger than it was before the late 1970s and early 1980s when it began recording a sustained current account deficit and became a debtor nation again. The gap between the United States and other major industrialized countries in terms of two key measures widened in the United States' favor over the past couple of decades: productivity and GDP per capita.

The current account shows the value of goods and services that cross national borders. It doesn't show anything else. When a U.S. company sets up an office in another country to manufacture and sell its goods according to specification developed in the United States, there is no import or export to show up in the balance of trade. That local operation is treated

as a local company, not as a U.S. operation. That's why many researchers would like to see a different approach to trade accounting, one that would look at who owns the goods and services rather than who buys them.

One such approach is called the *ownership-based framework* for the current account and is calculated by none other than the Commerce Department's Bureau of Economic Analysis. It is published every year as a parallel account report to the BOP—so it's clear that at least some people in government recognize the problem. It's possible that eventually this alternative will become the standard.

The most recent calculation, which was for 2007,<sup>8</sup> showed that the United States had exports of \$2.01 trillion under the ownership framework, compared to \$1.46 trillion under the BOP system. The trade deficit was *just* \$466.0 billion under the ownership approach, rather than \$700 billion for the balance of payments.<sup>9</sup> That shows just how much American companies are generating from business done by their international affiliates.

For all our complaining (which is our constitutional right), the United States has a stable government, deep and liquid capital markets, and common-law traditions that allow contract and property rights to evolve over time in a way that they can't if new statutes have to be passed every time something changes. It's an entrepreneurial approach to business that people all over the world envy. In America, people see investment opportunities that offer great returns for the amount of risk involved. That's attractive to people who live in places with economies that are fortunate to grow by more than 2 percent a year, such as Japan and Germany, or where there's tremendous uncertainty about national security, as in Russia. The current account is the difference between imports and exports. That's it. It does not capture the American business climate. An accounting equation is not an explanation or a driver for change.

## **Technologic Improvement (Progress) Costs More Jobs than Trade**

The United States has a high standard of living. Workers expect to be paid well for their efforts, so they devote their time and talents to things that pay well. Basic manufacturing once paid really well, but not anymore.

Although no politician who hopes to be elected or reelected will admit it, not all workers add the same amount of value to the economy.

Many manufactured goods are commodities these days: highly automated production that often assembles interchangeable parts that were produced elsewhere. People in countries that have a lower standard of living will work on an assembly line for less money than Americans (though generally with lower productivity, too). Manufacturing is more interesting and pays better than subsistence farming, but it's still hard work. Far better to be the engineer who designs the products that are eventually made in some factory somewhere else. The goods that Americans produce for export are usually manufactured with fewer hands than in decades past. The United States, for example, exports more steel now than at any time in its history, but fewer workers are required to produce it.

Trade isn't the most potent threat to traditional work and life styles; technology is. Farmers, factory workers, and office workers have all seen their work change because of technology. It's hard on those who have to make the transition, but it's not the fault of foreign trade.

Despite the hand-wringing about the U.S. trade deficit and the deindustrialization of America that it represents, the United States remains the world's largest manufacturer, accounting for more than one-fifth of the world's total manufacturing output as recently as 2005 (the most recent year for which comparative figures are available). Although factory output has not been higher (before the 2008 recession), fewer workers are generating it. From a peak of around 17 million factory workers in the late 1970s, manufacturing employment is approaching 13 million workers and falling.

The key here is productivity: output per person over a unit of time, such as an hour or a year. American manufacturing productivity has risen by 160 percent over the past thirty years. The same driver of labor-saving technological advances has seen workers replaced by machines in practically all countries, including China.

The same forces are evident in the service sector. The secretary function is largely missing in action in most offices. Should we look to China or maybe Puerto Rico or Mexico for these secretarial jobs? No. Bill Gates and Microsoft Office Suite have replaced them. Where are all the bank tellers? Diebold and NEC and the other makers of the ubiquitous ATM machine have downsized them. Not India, China, or Mexico.



## **Reality: The Balance of Payments Is a Poor Measure of American Strength**

Profits in a service economy don't come from slinging French fries: they come from the entire concept, start to finish. A group of Americans might form a company that invents a French fry recipe, designs the packaging, develops the brand, lays out the store, and writes employee training materials. Then they might offer this entire concept to someone in Asia who buys local land, contracts local builders who use local materials, hires local employees, buys local potatoes, and even uses a local printer to make the packaging. In other words, McDonald's exports a service: the ability to make its French fries anywhere. Nothing has changed hands, according to traditional trade accounting—only ideas. The related capital flows may be quite minor, limited to some licensing fee or royalty, but trade has surely taken place.

Accounting allows people to measure economic activity, but it rarely measures it exactly. When the BOP was established more than sixty years ago, its developers could not have imagined the economy in which we operate now. The old metric, the BOP and the system of trade accounting, no longer offers an accurate picture of how the global political economy works. It is based on a world that no longer exists. It undercounts the money that American companies make from global activities.

The BOP is not necessarily a fair measure of the economic competitiveness of a particular country. It does not measure the economic prowess of the United States. It raises more questions than it answers. The BOP overweights the value of finished goods and underweights the value of intellectual property. It doesn't reflect the way that multinational corporations operate, slicing, dicing, and distributing their operations around the world where it may make political and economic sense, for reasons that far outstrip comparative advantage as traditionally understood. And it causes people to make the wrong decisions that might actually hurt the U.S. economy.

Every month when the Commerce Department reports the trade balance and every quarter when the BOP data is released, the hand-wringing and chest-beating ritual is renewed. But at the same time, American household wealth has been rising right along with the trade deficit. Companies, individuals, and nations become great because they

invest in the future, often using other people's money. That creates deficits. Americans borrow money for college in hopes of earning more money in the future. They borrow money to buy houses. Even after the horrible financial crisis and the associated house foreclosures, a higher percentage of Americans will live in residences they own than nearly any other country. Japanese retirees buy U.S. treasuries in order to get 4 percent interest, higher returns than they can earn in Japan. Americans buy Japanese stocks through international mutual funds in order to diversify their retirement savings. We're all managing a series of deficits and surpluses, at home and abroad, in order to find stability for personal savings, finance government spending, or generate big profits, such as by selling pharmaceuticals to people who desperately need them.

The U.S. trade deficit isn't a measure of U.S. power. During the period that the trade deficit grew, Microsoft developed technologies that changed the way we all live, work, and play. General Motors became the largest foreign automaker in China. Coca-Cola and McDonald's both entered India. Researchers studying at American universities developed commercial applications for the Internet, which has made cross-border trade and communication possible at a scale that could not have been imagined in years past. If the accounting system doesn't show that, then the accounting system—not trade—should be changed.

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### Chapter Notes

1. U.S. Bureau of Economic Analysis, "U.S. International Transactions: First Quarter 2008." Washington, DC: U.S. Department of Commerce, June 17, 2008 (<http://www.bea.gov/newsreleases/international/transactions/2008/trans108.htm>).
2. General Motors Corporation. Press release. January 11, 2008.
3. U.S. Bureau of Economic Analysis, "U.S. International Transactions: First Quarter 2008." Washington, DC: U.S. Department of Commerce, June 17, 2008.
4. *Ibid* (p. 8–11).
5. Greg Linden, Kenneth L. Kraemer, and Jason Dedrick, *Who Captures Value in a Global Innovation System? The Case of Apple's iPod* (Irvine, CA: University of California, Personal Computing Industry Center, June 2007).
6. This is the subject of Alfred D. Chandler's Pulitzer Prize-winning book *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, MA: Belknap Press, 1993; original edition released in 1977).

7. Warren Buffett, "Squanderville versus Thriftville." *Fortune*, October 2003 ([http://money.cnn.com/magazines/fortune/fortune\\_archive/2003/11/10/352872/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2003/11/10/352872/index.htm)).
8. The most recent numbers just came out for 2007 as this book went to press. The Department of Commerce releases the numbers once a year, so there's a lag. The 2008 numbers will be available in January 2010.
9. U.S. Bureau of Economic Analysis, "An Ownership-Based Framework of the U.S. Current Account, 1998–2007." *Survey of Current Business*, January 2009 (Vol. 89, No. 1).

