The troubling economics and politics of the trade deficit

By THOMAS PALLEY
(First of two parts)

WASHINGTON, D.C. (PAI) — Over the last four years, the U.S. trade deficit persistently set new records, hitting $716.7 billion in 2005, equal to 5.7 percent of Gross Domestic Product (GDP). That high figure has both real and financial effects. Real effects are impacts on employment, incomes and manufacturing capacity. Financial effects refer to the impact of accumulated indebtedness from borrowing money abroad to finance the deficit.

One important real effect has been the deficit's contribution to making the alleged current recovery the weakest since World War II. The Commerce Department estimates the trade deficit directly reduced GDP growth by over 25 percent between 2001 and 2003 by channeling spending to foreign rather than domestic goods.

Its estimate excludes additional indirect losses stemming from the fact that lower spending on domestic production meant fewer jobs, in turn causing the U.S. economy to forfeit the spending and growth that those jobs would have generated. This adverse impact continued in 2004 and 2005.

All economists acknowledge economic growth is hard to come by, yet U.S. policymakers casually ignore the trade deficit's negative growth effects. From 2001-2005 the trade deficit directly reduced U.S. growth by an annual average of 0.47 percentage points, and that excludes the additional growth that would have come from spending and investment induced by faster job and output growth.

Robert Scott of the labor-backed Economic Policy Institute think tank calculates each $1 billion of imported goods embodies approximately 9,500 jobs. Stripping out the OPEC oil deficit of $92.7 billion, the goods trade deficit in 2005 was $695 billion. Using Scott's estimate, this implies the trade deficit lost us 6.6 million job opportunities.

Not only does the trade deficit negatively impact employment and output, it has lasting adverse impacts on U.S. manufacturing. Behind the trade deficit is a problem of lack of competitiveness that is significantly due to undervalued exchange rates in the rest of the world.

Such under-valuation makes foreign goods cheaper relative to U.S.-produced goods. Given this competitive disadvantage, many U.S. manufacturing companies closed plants. That reduced manufacturing capacity. Some companies went out of business, while others re-located or sub-contracted production, particularly to China.

American University economist Robert Blecker examined the impact of the over-valued dollar on U.S. manufacturing investment. He estimates the increase in the value of the dollar from 1995-2004 lowered U.S. manufacturing investment by 61 percent. It also lowered U.S. factory capacity by 17 percent relative to what it would have been in 2004 had the dollar remained at its 1995 level.

This structurally weakened the U.S. industrial base. It also makes the future task of trade deficit adjustment more difficult as the U.S. may now lack the capacity needed to produce many of the manufactured goods it currently imports. These developments have implications for future U.S. living standards.

Manufacturing is key to long-run prosperity. It is a major source of innovations and productivity growth that drive increased income. A smaller manufacturing base means a smaller base from which to draw such benefits. And when factories move offshore, so do their research and development activities, diminishing future innovation.

The trade deficit also carries significant adverse financial implications. Growing debt abroad that results from borrowing to finance the deficit makes U.S. financial markets vulnerable to a loss of confidence in the dollar. If investors — foreign or domestic — no longer wish to accumulate dollar-denominated assets, the dollar stands to fall and interest rates, including car and home loans, will rise as investors exit the economy.

Higher interest rates would then have severe adverse effects given the high debt of American households. And dramatic weakening of the dollar would likely accelerate inflation because of heavy reliance on imported goods and limited domestic factory capacity to replace them.

And the trade deficit also has national security implications. Heavy reliance on imports and the erosion of manufacturing capacity could potentially expose the U.S. to global economic disruptions. These economic security concerns are amplified by the special role of China, which now accounts for almost 30 percent of the trade deficit.

There is considerable uncertainty whether China will evolve into a democracy that shares U.S. values, or whether it will remain an authoritarian state and become an outright hostile geo-political rival.

China is now the world's second largest holder of U.S. treasury debt, it has the largest trade surplus with the U.S., and many U.S. companies are investing heavily in production plants in China and transferring state-of- the-art manufacturing technology there. These developments give China real and financial leverage over the U.S. economy. Given the uncertainty surrounding the U.S.-China relationship, this leverage is a major national security risk.

(Editor's Note: Thomas Palley is the former chief economist of the AFL-CIO and former chief economist of the U.S.-China Commission, a congressionally-created panel that monitors U.S.-China trade and economic relations. This and other economic analyses can be found on www. thomaspalley.com. Part II will appear in the Dec. 15 edition of the NW Labor Press.)

Labor's Yuletide toy drive needs gifts by Dec. 15

Labor's Community Service Agency and the Northwest Oregon Labor Council will hold their 10th annual Presents from Partners Holiday Toy Drive for underprivileged children.

Bring unwrapped gifts for children of all ages to the NOLC office at 1125 SE Madison, Suite 100-D, Portland, no later than Friday, Dec. 15.

Gifts will be distributed Saturday, Dec. 16, at 1 p.m. at Genesis Community Center, 5425 NE 27th off Killingsworth.

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