

Do trade deficits matter?

As generations of first-year economics students have learned, international trade benefits nations when they specialize in producing those goods and services in which they have a comparative advantage and letting other nations specialize where they have an advantage. Each nation will then export things where it has an advantage and import those where it doesn't.

But some argue that importing goods or services costs jobs here in Canada. It is true that, when a foreign company displaces a Canadian company in manufacturing a product, there can be a direct job loss. But Canadian consumers now can purchase this good at a lower cost, thanks to the foreign supplier, and the extra money they have is available to buy more goods or services. Other jobs are created – and the consumer is better off. Self reliance or sustainability may be an old-fashioned virtue, but it's not the way for people or economies to prosper. By specializing and trading, economic outcomes improve.

It's also hard to make the case that trade surpluses create jobs or that trade deficits kill jobs. Canada, for example, is a major exporter of traditional forestry, fisheries, and agricultural products. In the last decade, our trade surplus more than doubled from about \$5 billion to \$12 billion. Over the same period, employment in those industries fell by nearly a quarter. As another example, the United States has had trade deficits in every year since 1976, and yet employment and GDP continued to grow.

A trade surplus, however, can leave a country vulnerable to swings in global demand. Stephen Roach argues that the export driven growth in Asia “leaves the region in a very uncomfortable place.” For example, as China increases its dependency on exports for economic growth and maintains a surplus, it increases its economy's susceptibility to volatility in international markets. This will prove to be increasingly challenging as the primary markets for China's exports – the United States and Europe – suffer from the aftermath of the economic

crisis.^a The same happens in Canada, as 63 percent of Canadian trade in 2009 was with the United States; without a hedge, any swings in demand for goods and services there will always severely hurt Canada's economy.^b

Then, what happens when a country has a trade deficit? People elsewhere accumulate the currency of the deficit country – the currency they received when they sold the goods or services. This currency can be invested in the country of origin. Hence trade deficits are matched exactly by capital surpluses – the currency that leaves the country when foreign goods are purchased returns as investments. If there is little demand for investing in the country with the trade deficit, then the value of the currency will decline. With fewer people wanting to hold or invest in the currency, its exchange rate drops. When a currency becomes devalued the country's exports are cheaper – which reduces the trade deficit, as trade increases. And equilibrium is achieved.

The relationship between our trade balance and prosperity is weak (*Exhibit A*). The worst performing year for both trade and GDP was 2009 when we experienced our first deficit in many years and GDP fell 2.6 percent from 2008 – the worst decline in decades. Few would argue that Canada's poor economic performance in 2009 was caused by our trade deficit. In fact, if this outlier is removed from the analysis in *Exhibit A*, the weak statistical relationship vanishes.

So what can we say about Canada's deficits with specific countries? Bilateral deficits are meaningless. A nation can have a trade deficit with another country, and yet be in surplus with the world. Canada has recurring trade deficits with many countries representing the full range of economic success – Bulgaria, Jamaica, Japan, Mexico, Nicaragua, Portugal, and Singapore to name a few. Yet our economic performance matches or exceeds that of most of those countries. Nobel laureate Robert Solow observed that he has a chronic deficit with his barber, buying haircuts from him but never once selling him an economics lesson.

^a Stephen S. Roach, “The consumption gap,” *Foreign Policy*, July 21, 2010, available online: http://www.foreignpolicy.com/articles/2010/07/21/the_consumption_gap

^b Trade Data Online (TDO), Industry Canada, available online: http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php#tag

The trade deficits that attract most attention are those of the United States with China – the main source of so-called “global imbalances.” These deficits are of unprecedented size, and some fear that they have the potential for global destabilization.

Bruce Little and Robert Lafrance of the Bank of Canada examined the situation and point to three schools of thought. Optimists conclude that the US trade deficits are the mirror image of capital surpluses. Investors in China and elsewhere see opportunities in the US economy and want to participate. If this situation changes, market forces will automatically correct the imbalances. Pessimists are concerned that US trade deficits reflect an unwillingness of US governments and consumers to live within their means and China’s unwillingness to lower prices of imports for its consumers’ benefit and to invest in its own infrastructure. While this continues, there is a serious risk that China will no longer want to hold US currency, and a major upheaval could occur. Those in the middle ground remain hopeful that market forces will gradually unwind the global imbalances. They believe that gentle pressure on the United States will force

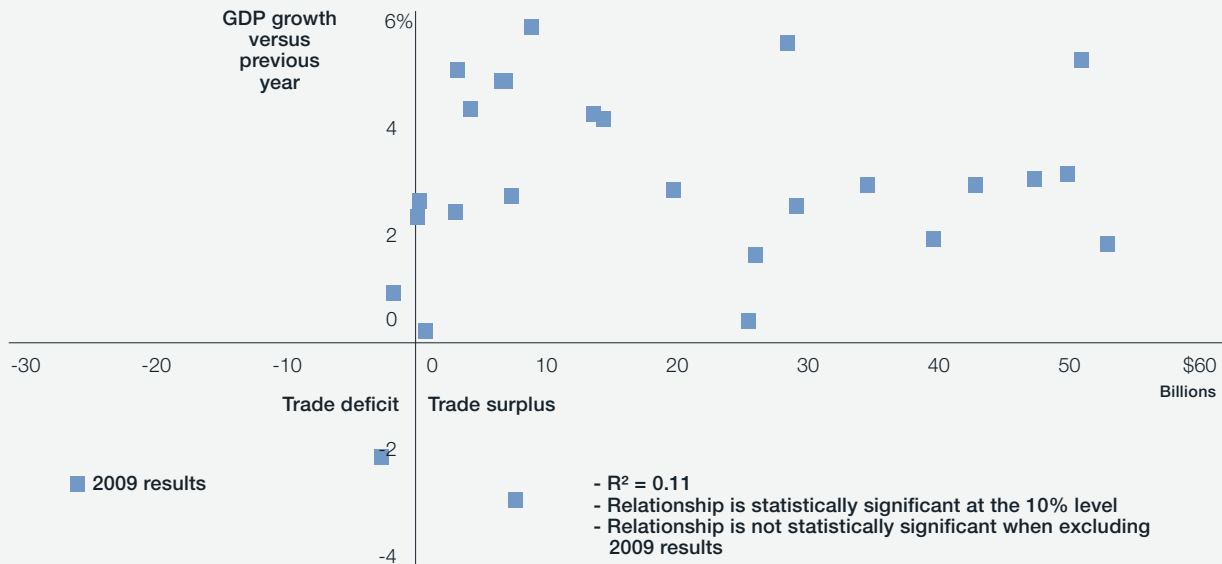
savings up and on China will reduce its growing trade surpluses through currency appreciation.

The global imbalance associated with the US trade deficit may have the potential for a serious negative impact on the global economy – but here in Canada there is little we can do about it. For us, an annual trade deficit with the world doesn’t really matter; nor does a trade deficit with a particular country. What does matter is trade volume. As trade increases, firms become more competitive, they invest in innovation, and increase hiring and wages. Then, productivity increases, and consumers have more choices and enjoy lower prices. Ultimately, an increase in trade volume leads to an increase in total economic output and thus improves overall well being.

Clearly, trade is not a zero-sum game – rather, “it allows all countries to achieve greater prosperity.”^c

Exhibit A Canada’s trade balance and GDP growth show little relationship

**Trade balance and GDP growth (goods and services), 1981-2009
(Constant 2009 C\$)**



Sources: Institute for Competitiveness & Prosperity analysis using data from Statistics Canada, CANSIM table 3800027.

^c N Gregory Mankiw, *Principles of Economics*. Thomson Learning, 2007