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Avoid deficit phobia

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Saying China outsources too won't reassure anyone

World Trade Organization director-general Pascal Lamy, who for the last five years has been wandering the world trying to wind up the WTO's now almost 10-year search for a "Doha Round" trade agreement, was sighted this week in the Financial Times, writing about how we measure trade.

His point, making use of a recent study about Apple's iPod that has made a big splash, was that in an era of global product chains many things we buy aren't really imported from any one country but instead contain inputs from many countries. For example, China is the country that puts the final touches on the wonderphone and so gets official credit for producing it, but most of the value-added comes from elsewhere, including the U.S. Unfortunately, official trade statistics don't recognize the phone's polyglot origins but instead categorize its full value as originating in China.

Lamy drew a number of lessons from this observation. The first was that interfering in complex global sourcing by putting up trade barriers can be very disruptive to business, which is certainly true. On the other hand, the more places there are that can potentially take over parts of the job the more likely it is that interference will backfire against the interferer. So countries meddle at their own risk. If you're the sole supplier of a crucial ingredient to the mix, maybe you can steal value from all down the chain. But, for the vast majority of products and processes, who has that kind of monopoly power?

A second lesson is that Americans needn't get so excited about their trade deficit. The trade statistics may give a lot of credit to China, but the economic reality is that many Chinese products are the joint output of several countries: China itself outsources significant parts of the job to other Southeast Asian countries, so the U.S.'s mega-deficit is really with a bunch of countries, not just China. Which means it's not as bad as it seems.

That right? Well, yes and no.

The products China sells to the U.S. do generate payments from the U.S. to China and as China sells lots more products to the U.S. than vice versa, the dollar flows are big. Some of that money does come directly back to the U.S. or on to other countries to cover the costs of purchased inputs. And of course the Chinese funnel a lot of the rest of it back to the U.S. in the form of investments, whether in treasuries or real assets. But there's no

getting around the fact that there are big outflows from the U.S. The invoice has to be paid, even if it not all the money either goes to China in the first place or stays there long.

Lamy's logical strategy is to accept that trade deficits are bad, but then to say the American deficit with China isn't as big as it seems. A different strategy would be to say that almost no matter how big they are, deficits may not be as bad as we believe. The world itself can't have a trade deficit or surplus, not until interplanetary trade comes along, at least. Until then, all the world's surpluses and deficits have to sum to zero: if some countries have surpluses, others have to have a deficit. There's a famous paper in economics called "Deficit, deficit, who's got the deficit?" that gets the hot-potato spirit of the thing across. Given that somebody has to have a trade deficit, on just what basis do we decide when deficits get too big?

Though a country's trade deficit almost never exactly balances, its overall international payments always do: every transaction has two sides. So the good news behind a trade deficit is that any country experiencing one must also have a capital account surplus. For any of many possible reasons, people in other countries want to invest in yours. The money that comes into your country that way goes back out when your citizens buy other countries' goods. It's the great circle of international economic life. Maybe as a long-run debating strategy, Mr. Lamy would be better off emphasizing that fundamental, rather than giving in to deficit phobia but then trying to low-ball the numbers.

A second part of his strategy is to accept Americans' anxiety about China but to reassure them that here, too, the numbers aren't really as bad as they seem. China is also a habitual out-sourcer. That doesn't seem likely to calm American fears. It may take down the image of the Chinese as 21st-century supermen, just as the Japanese were in the 1980s, but a lot of Americans will figure that if the Chinese didn't subcontract to the Vietnamese and Malaysians, they probably could do it all themselves. In any case, they'd be very unlikely to farm it out to Spokane or Sheboygan.

The current surge of interest in interventionist policies to restore Americans' competitiveness — see both Barack Obama's State of the Union speech and Make it in America: The Case for Reinventing the Economy, a new book from the president of Dow Chemical — won't really be blunted by data that says the world's manufacturing isn't all going to China, some of it's also going to Malaysia and Vietnam.

A "reinvented" American economy is bound to feature tax loopholes and special favours for manufacturing of exactly the sort Mr. Obama has just pledged to remove from the corporate tax system. Arguments about the iPhone are well and good, but the only thing that's really going to stop neo-protectionism before it gets revved up is a gallumphing decline in U.S. unemployment. That may now be in the wind, but can't come too soon.

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