

Trade Out Of Whack

Making sense of the trade deficit

By STEVE STEIN

IN OCTOBER, THE United States posted a 12-month trade deficit of nearly \$600 billion. That figure has been rising steadily and breaking its own record month by month. Each increment adds to the United States' external debt, which is now estimated at over \$2.6 trillion. The chart below shows how each has been increasing as a percentage of GDP.

Are these increases in the trade deficit and the external debt matters of great immediate concern? No, say a remarkably large number of respected economists, adding that the only imminent danger in these figures is that they might provoke unwise but irresistible calls for protectionism and other equally harmful measures.

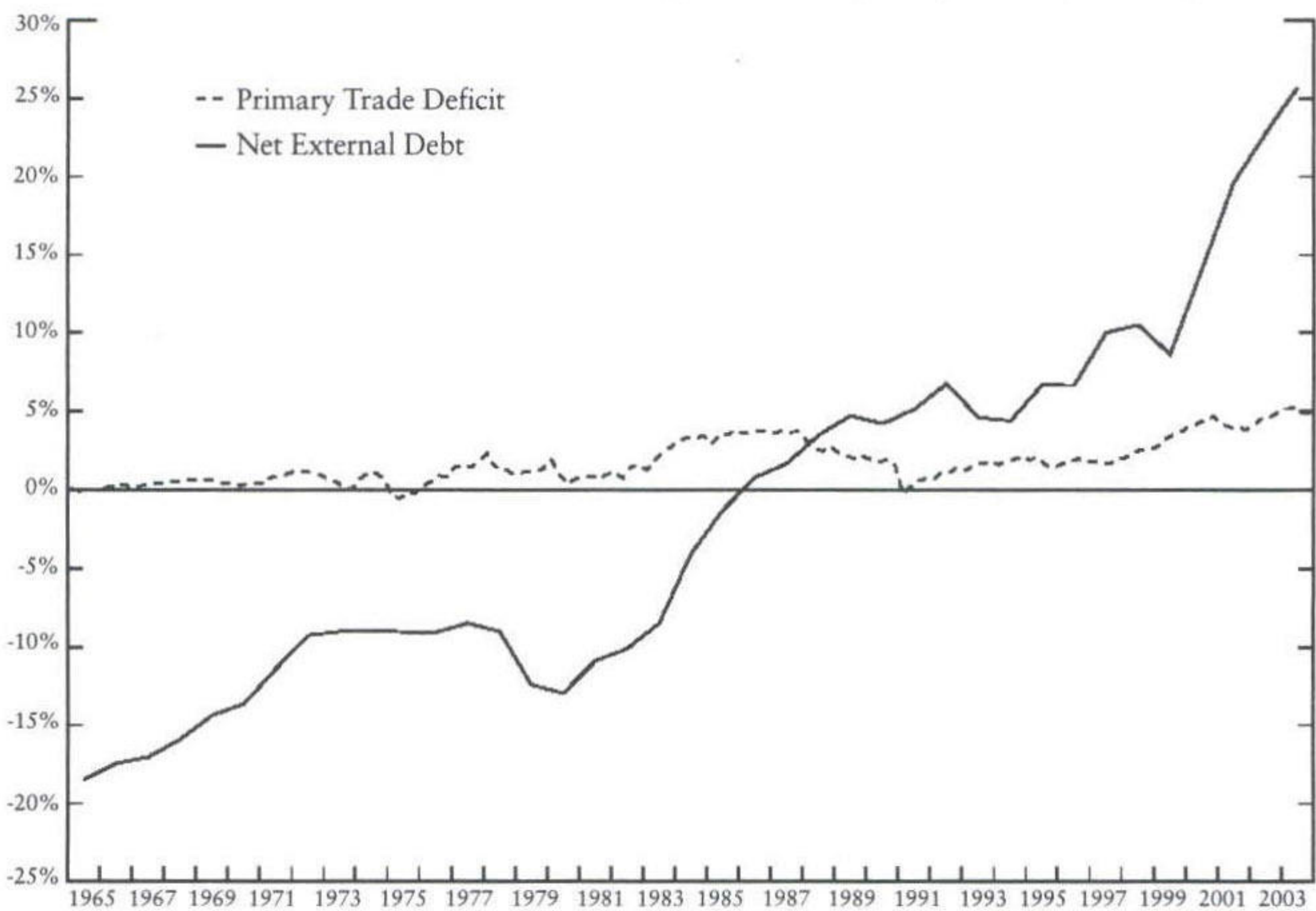
One of those respected economists is Federal Reserve Board Chairman Alan Greenspan. Addressing a bankers' conference in May, Greenspan acknowledged that the trade deficit, at over 5 percent of GDP, was testing historic limits, especially since it was accompanied by a record budget deficit and record household debt. So why isn't Greenspan alarmed? Because, as the chairman said, the United States is simultaneously benefiting from a "one-time shift in the degree of globalization and innovation." Rapid industrialization and freer trade have lowered the cost of merchandise. The internationalization of investment and banking, coming at a time when America's robust capital markets are so attractive throughout the world, has

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lowered the cost of credit. The growing flexibility of world financial markets has made it easier for equity prices, product prices, and exchange rates to reestablish global balance without the sort of abrupt impacts on the U.S. economy that create crises.

However, Greenspan stressed that one-time shifts don't last forever, and lately his optimistic outlook appears somewhat dampened by the large and ongoing accumulation of dollar assets by Asian central banks. In November,

U.S. External Debt and Primary Trade Deficit (share of GDP)



Source: Bureau of Economic Analysis and FRB calculations.

when he told another banking conference that “net claims against U.S. residents cannot continue to increase forever in international portfolios at their recent pace,” Wall Street reacted as though it had received new and unpleasant information. At any rate, those massive currency interventions, particularly by China and Japan, have kept the dollar artificially high and Asian imports artificially cheap, and they trouble some economists much more than they do Greenspan. Former Treasury Secretary Lawrence Summers, for one, worries that the United States has found no effective way of preventing these currency transactions.

In fact, Summers shares little of Greenspan's calm view of the trade deficit, and is especially concerned about the geopolitical implications of the rising external debt. “There is surely something odd,” Summers told a group at the International Institute of Economics, “about the world's greatest power being the world's greatest debtor.” He has a point. While it isn't easy for other nations to use the threat of calling that debt in order to achieve other political ends, neither is it impossible. The situation of the U.S. today stands in sharp contrast, for example, to that of the British Empire in the

nineteenth century, when it was both the world's major power and major creditor.

Divided commission

IT IS NO SURPRISE that a Federal Reserve chairman and a former secretary of the Treasury from different political parties view a highly charged issue like the trade deficit from dissimilar perspectives. International trade has always been a subject from which professionals can draw vastly different conclusions using the same set of facts. At least Summers and Greenspan do share large areas of agreement, which is more than can be said of some of their colleagues.

When Congress established the Trade Deficit Review Commission in 1999, it may have foreseen an end product that would represent bipartisan consensus. The commission's final report was well-researched and thorough, but bipartisan it definitely was not. Most of its chapters consist of a set of Republican recommendations and Democratic recommendations; the two could hardly be farther apart. Since the two blocs on the commission saw the causes, consequences, and sustainability of the trade deficit so differently, it wasn't surprising that they had different views as to what to do about the problem (or even whether there *was* a problem). The final report was not a likely document upon which to base law or policy. The only ones happy with the report were those who believed that legislative gridlock was insurance against overly intrusive government — a not uncommon view during the heady bull market of 1999 and early 2000.

The chairman of that commission was Murray Weidenbaum, formerly chairman of the Council of Economic Advisers. Weidenbaum told an audience at a Cato Institute conference that the Republicans originally had no intention of writing separate statements. They decided to do so only after the Democrats had surprised them with the announcement that they were writing their own versions of several chapters. So in the final report, the Republicans emphasized the benefits of imports, and the Democrats emphasized importers' effects on the domestic job market. Republicans emphasized the quality of the United States' capital markets, which made it much easier for foreign capital to come here than for American capital to go abroad. Democrats emphasized the dangers of so large an external debt.

And so the commission's report went, chapter after chapter. The causes of the trade deficit? Republicans saw them mainly in macroeconomic terms: "In the 1990's, the relative strength of the U.S. economy led to substantially increased imports, while the relative weakness of many of our trading partners led to much slower growth in exports." Democrats saw other factors at work: "Unequal relationships with America's major trading partners. Predatory practices, such as dumping, that have increased U.S. imports. Foreign government subsidies The failure of other nations . . . to

enforce their labor and environmental laws.” The only major cause that both sides agreed on was the low rate of savings in the United States, and even on this point, there were vastly different emphases.

The two sides were even farther apart regarding the consequences of the trade deficit. The Democrats saw “A sharp rise in income inequality since 1979 . . . elimination of millions of good manufacturing jobs . . . depressed wages . . . and declining U.S. competitiveness on world markets.” The Republicans saw a trade deficit that “had played a very important role in rising U.S. prosperity . . . rapid economic growth, a higher U.S. standard of living and job creation . . . and helped keep inflation low.”

Nor did the two blocs see eye to eye on the sustainability of the trade deficit. Few would suggest that large trade deficits can continue forever, but “sustainability” is much more narrowly defined in the area of international trade. Economists generally speak of trade deficits as sustainable if they are likely to diminish gradually through market forces and without sudden currency devaluations or traumatic recessions. The commission’s Republicans thought this was probable; the Democrats did not.

If, today, a successor panel were to reexamine the trade deficit (or the current account deficit, a slightly broader measure that includes interest and dividend payments), might it achieve more practical conclusions? Maybe such a panel should *start* with the sustainability question. After all, if it turns out that the trade deficit will ultimately adjust itself without problems for this generation or the next, wrangling over the deficit’s root causes or possible consequences may not be a valuable use of time. But if sustainability is doubtful, then finding common ground on the causes of the trade deficit takes on new urgency.

Sustainability 1: Debt

IN THE TRADE Deficit Review Commission’s report, both the Democrats and the Republicans cited a book by Catherine Mann, a senior fellow at the Institute of International Economics, titled *Is the U.S. Trade Deficit Sustainable?* (1999), which remains an authoritative work on the subject. The book generally concludes that America’s ongoing trade deficits are unlikely to produce any sudden flight from the dollar or any other crisis of the kind associated with a large buildup of foreign debt in weaker economies, but the experience of the past four years, including the return of large budget deficits, has led Mann to add two caveats. The first is that a somewhat unhealthy relationship, or “codependency,” has developed between the United States and several of its Asian trading partners. The Chinese and Japanese continue to support our currency and finance our debt in order to protect their export markets, and we continue to pursue policies that make their support necessary.

Mann’s second caveat, as she explained in a recent telephone interview, is

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more subtle. The very size of the American economy, combined with the strength of its capital markets and banking system, forestalls the typical monetary pressures that international markets normally bring to bear — mainly exchange rate adjustments — which then cause imports to fall and exports to rise. Prolonging the period of high trade deficits increases the likelihood that some major unforeseen event will upset the applecart.

By definition, the precise nature of such an event is unpredictable, but in light of recent experience, some possibilities can be envisioned. Consider, for example, the crisis in the autumn of 1998 precipitated by the collapse of Long Term Capital Management, the highly leveraged currency trading hedge fund. The collapse could have precipitated a liquidity crisis had the Federal Reserve Board not decisively managed the necessary infusion of cash into the banking system. At the time, foreign central banks were not players in that process. Yet today, with over \$1.6 trillion of dollar reserves held by Japan, China, Taiwan, and Korea, would their central banks be content to remain mere spectators if an LCTM-type crisis loomed? Or if not, would their independent currency moves exacerbate the situation rather than help it?

Currently our large external debt is financed at such low interest rates that the debt service is fairly easily offset by the growth of our domestic economy. As interest rates rise, the economy will have to perform even more strongly.

Sustainability 2: Equity markets

IT IS A SIMPLE accounting truth that every dollar of the current account deficit has to be offset by a loan from foreigners or a sale of assets to them. Most of the lending is in the form of government securities and, rightly or wrongly, is seen as closely related to the size of the budget deficit. Financing the trade deficit by sales of assets — publicly traded stock, real estate, or private businesses — is seen as somewhat more benign. Most such sales are between businesses and individuals, rather than governments, and thus seem part of the trend toward globalized markets.

But financing trade deficits through equity purchase also has limitations. One constraint is that foreign portfolios, especially those that already contain U.S. Treasury instruments, can become uncomfortably concentrated in American securities. The higher the concentration of U.S. securities, the more skittish foreign money managers may become in difficult times. Parts of the equity market are notoriously volatile, as illustrated by the 75 percent decline in the NASDAQ from its high in March 2000 to its low in September 2002. Had foreign holdings been an even larger share of the market than they were, the NASDAQ's downdraft might have spread even farther. So what will happen in the next down-market cycle? The global integration of capital markets is a factor that is supposed to *add* stability to the system, but

surely it can work both ways.

The connection between the equity markets and the trade deficit also points to an even broader concern: Every dollar earned from an export to America and reinvested in an American stock represents a decision that this particular American company will itself be a strong revenue and profit producer. In an increasingly global economy the logical assumption is that much of that revenue will come from foreign trade.

There's a slight problem here. For decades, optimistic trade economists have been saying it's OK to run trade deficits today if they're financing the promise of greater productivity tomorrow. Sooner or later, the continuing existence of the trade deficit *itself* casts doubt upon the credibility of the

The dollar is the preferred medium of exchange, so other nations want to keep its value stable.

promise. This is not a question of America's ability to innovate. It is a question of America's ability to reap the market benefits of that innovation. During the height of the NASDAQ bubble, the conventional wisdom was that the Internet changed everything, but the unanswered question was always, "How then do you make money out of it?" The venture capitalists and the investment bankers knew how: float an IPO and execute a good exit strategy. But if the subject is "sustainability," that isn't very comforting.

As always, winners and losers emerged, and now the Internet is certainly producing lots of revenue for the former. Moreover, many of its successes might never have happened if the American economy had followed the example of those of its trading partners whose economic systems try to pick winners and losers in advance. But consider how dramatically the process is speeding up. As Ernest Preeg, a senior fellow at the Manufacturer's Alliance, pointed out recently, even in the area of highly advanced technology products (ATP), United States trade has gone from a surplus of \$30 billion in 1998 to a deficit of \$27 billion in 2003. Sectoral deficits in "information and communications" and "life sciences technology" simply don't square with the notion that America will muddle through its other trade problems by maintaining its technological edge. As Preeg suggests, sooner or later a trade deficit in advanced technology products begins to put pressure on R&D expenditures, threatening future innovation itself.

American companies earned strong profits from the manufacture of television sets for decades, before the comparative advantage in that business went entirely abroad. Today, the profit-generating products of major industries become "commoditized" more quickly. As this shift from high margin business to low-margin business occurs, the pattern in many American firms has been to move on to newer products where the margins are still strong. Among the other things that a rising trade deficit tells us, it signifies that the search for high-margin businesses is becoming more arduous. Attracting

capital to finance those businesses may become more difficult as well.

Sustainability 3: The dollar

OPTIMISTIC SCENARIOS THAT foresee the trade deficit gradually diminishing typically assume that the dollar will remain the world's major reserve currency. The experience of the past 50 years shows that the dollar can lose value against other strong currencies but still be the currency of choice for settling international accounts. As recently as 1971, the dollar was worth 357 yen and 4.31 Swiss francs; at the time of this writing, it is worth 107 yen and 1.20 francs. The dollar also lost more than half its value against the German mark from 1971 until that currency was phased out by agreement with the European Union a few years ago.

The International Monetary Fund estimates that over 65 percent of all foreign reserves are still held in dollars. The dollar's closest competitor, the euro, comprises only about 20 percent of foreign reserves. The United States obtains considerable economic advantage from the dollar's reserve status. Major commodities, such as oil, wheat, and copper, are generally invoiced in dollars, which means that American dealers in these items don't have the currency risks or hedging costs of their foreign competitors. This economic advantage builds on itself: Since the dollar is the preferred medium of exchange, other nations have an interest in keeping its value stable. The massive interventions by Asian central banks have drawn deserved criticism as currency manipulations designed to protect their own exports. But the Chinese and Japanese have additional interests in the dollar's stability. Like us, they are huge importers of oil, which is still priced in dollars, and they recall the oil shocks of 1973 as vividly as we do. If China were to revalue the yuan against the dollar, it might temporarily be able buy oil a little more cheaply — but at the risk of significant market volatility in the future.

Has the dollar's reserve currency status tempted America into overreliance on imports simply because it is able to print money to pay for them? Certainly, there are advantages of having a currency in whose value everyone has a stake. The situation has been caricatured as other countries having a comparative advantage in producing goods and America having a comparative advantage in producing money to pay for them.

Protectionists see America's trade deficit as the product of just such a dream world, with little hope of self-corrective feedback developing in time to avert crisis. Some of this can be dismissed as the scare talk of the politically disaffected; after all, America's monetary policy has been quite carefully managed, especially for the past several decades. But Warren Buffett, chairman of Berkshire-Hathaway, is no disaffected outsider. He worries that the United States may experience the "abrupt shutoffs of credit that many profligate nations have suffered in recent decades." Nor is Federal Reserve Board Governor Edward Gramlich an outsider or a protectionist, but he has his

own concern that market forces may not work smoothly and efficiently to revalue the dollar. As Gramlich noted in a speech to the Euromoney Bond Investors Congress in London (February 25, 2004):

Countries with large trade deficits often have their external liabilities denominated in a foreign currency. Hence, when their own currency depreciates, the value and burden of foreign debt automatically increases. The United States does not have this problem because most of its debt is denominated in dollars — say, foreign holdings of U.S. Treasury bills. If the dollar were to fall, the value of our debt in terms of foreign currencies would then automatically decline, inducing foreign wealth-holders to make further portfolio shifts, perhaps even including increasing their stock of dollar-denominated debt. This denomination effect would not permanently prevent any relative price adjustment, but it could lengthen the process.

The United States has held commanding economic status for so long that we need to remind ourselves this is not a preordained condition. When the country first established the Federal Reserve System in 1913, the U.S. economy was already more than three times the size of its two closest rivals, Great Britain and Germany. Because of the effect of World War I on England's finances, the dollar soon replaced the pound as the leading reserve currency. By the end of World War II the United States had the *only* viable major economy. In 1944, the conference at Bretton Woods, New Hampshire agreed that every participating nation's currency would be fixed to the dollar and the dollar would be fixed to gold — an unprecedented concentration of economic power.

Bretton Woods worked reasonably well until the mid 1960s, when the United States experienced rapid inflation and the dollar's official exchange rate — \$35 per ounce of gold — began to lose credibility. When Richard Nixon "closed the gold window" in 1971 and announced that the dollar would be allowed to float, it was seen as a setback for U.S. international monetary policy. Actually, demand for the dollar as a reserve currency has increased. The OPEC cartel, for instance, drastically raised the price of oil but nevertheless continued to price it in dollars, which were still seen as the world's safest currency. The "petro-dollars" that resulted from this arrangement represented a claim on U.S. assets but also added to the attractiveness of the U.S. as an investment target. The three years of back-to-back double-digit inflation from 1979 to 1981 resulted in some flight from the dollar to gold, but not to other currencies.

When the Federal Reserve regained a firm grasp of monetary policy and reined in both the money supply and inflation, even the combination of large trade deficits and large budget deficits that existed in the late 1980s didn't threaten the dollar's reserve currency status. So when we again hear warnings of the impact of the trade deficit on the dollar, is this not another case of crying wolf?

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Possibly not. As Nobel Laureate Robert Mundell told an audience in Buenos Aires in 2000, "Currency power configurations . . . evolve along predictable lines with the growth and decline of nations. . . . Now, at the close of the 'American century,' the euro has appeared as a potential rival, the countervailing power, to the dollar." Another currency expert, Stanford economist Ronald McKinnon, believes that if the euro had been created in the 1970s when the dollar was relatively much weaker, it might have been an immediate challenger as the dominant reserve currency.

Serious talk has already begun about an East Asian equivalent to the euro. Increasingly, Asian central banks are experimenting in currency swaps designed to safeguard against the type of speculation that precipitated the "Asian contagion" of 1997, when the currencies of Thailand, Malaysia, Indonesia, and South Korea collapsed so dramatically. As the *Wall Street Journal* noted in an editorial (June 8, 2004), "the main obstacles to an Asian 'euro' are political." If Japan and China, in particular, reach a required level of mutual trust, it is conceivable that the requirements for a currency configuration such as Mundell describes will be nearly met.

So the dollar may have to share reserve status with other currencies, regardless of the future patterns of our foreign trade. That may turn out to be no particular detriment, but shouldn't the dollar's loss of supreme reserve status be factored into trade forecasts? When an optimistic economist claims that the best thing to do about the trade deficit is to allow natural economic forces to take their course, those forces should include the possible diminution of economic leverage America obtains from the dollar's reserve status.

Asking whether the dollar is "too big to fail" is too apocalyptic a question, but the related inquiry — might the dollar become a lot smaller in the future? — is sobering precisely because it is more realistic. Thus, there is enough uncertainty about the trade deficit's sustainability that it becomes necessary to face the subject that "trade libertarians" don't like: Are other countries' national trade policies creating disadvantages for us that aren't offset by the operation of the free market?

American competitiveness

POLICIES THAT DIRECTLY target the trade deficit can easily morph into protectionism. Therefore, some economists prefer to focus almost entirely on causes of the trade deficit that relate to the state of the entire economy — the "macroeconomic" causes. Chief among these is America's low rate of savings, which, since the early 1980s, has declined from over 8 percent of GDP to less than 2 percent. The Germans, whose labor costs are even higher than our own, run consistent trade surpluses. The most obvious difference is the two countries' savings rates.

But as one of the few consensus sections of the Trade Deficit Review

Commission report stated, "Waving a magic wand over U.S. consumers and producing an increase in national saving of \$400 billion would not simply eliminate the trade deficit." The relationship between capital flows and trade flows is much more complex than that. A higher savings rate might be desirable for many reasons. But from 2001 through 2003, maintaining a high level of consumption appeared to be the only way to stave off recession, since business investment opportunities often seemed so dismal.

Sometimes we discount the obvious: One element of the trade deficit is that, historically, exporting just hasn't been a high priority in America. Catering to the export market is an ingrained tradition for our trading partners, but not for us. Separated by two oceans and favored with a huge economy able to consume most of what it produced, most American industries never needed to develop large export markets. In 1960, foreign trade amounted to less than 7 percent of America's total GDP, whereas in most Western European countries it was over 25 percent. As globalization has gained momentum, trade has increased to about 20 percent of GDP for us but is now 50 percent for Europeans. The experience of the fast-growing Asian economies closely resembles the European experience, and for a city-state like Singapore, trade averages nearly 300 percent of GDP.

"Export or die," a popular campaign poster in post-World War II Britain, became a sentiment embraced seriously by the Japanese. Both of those island nations perceived their ability to sell abroad as vital to maintaining their standard of living. While the British believed in free trade and the Japanese were strongly protectionist, each country considered exports vital, as did the Koreans and Taiwanese, taking Japan as a model. Continental European nations, in direct proximity to each other, often saw exports as a natural extension of domestic economic activity.

Finally, there is China. Although their history includes a long, disastrous period of isolation, the Chinese have learned from their mistakes and their neighbors' successes and have turned exporting into a national obsession. A recent electronics show at the Shanghai Exhibition Center advertised that it gave "buyers from around the world direct access to hundreds of *export-quality* manufacturers from Greater China, all under one roof." "Export quality," a term often used in poor countries like Sri Lanka and Bangladesh, suggests that the best merchandise is somehow reserved for outsiders. It's not a phrase most Americans would appreciate from domestic manufacturers.

Protection and subsidies

THE LARGEST COMPONENTS of the trade deficit are petroleum, consumer goods, and automobiles. Even though the U.S. also has large auto and truck exports, its imports are far greater. For both automobiles and consumer goods, several administrations have occasionally

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attempted to combat the tactics of some of our trading partners. These efforts tend to be even greater when it comes to protecting America's competitive position in heavy industry, and nowhere are the political pressures to protect or subsidize industry stronger than for steel. Far more steelmaking jobs have been lost to gains in productivity than to foreign competition, but that unemployed steelworker in Youngstown, Ohio remains a powerful symbol of unfair competition, partly because the symbolism retains an air of plausibility.

When nations become intent upon rapid industrialization, there is something about steelmaking they seem to find irresistible. The Soviet Union poured extraordinary resources into its steel plants even when the country couldn't adequately feed itself. Lenin's successor, Josef Dzhugashvili, adopted as his last name a word that means "man of steel" — Stalin.

But even for market economies, investment in the steel industry is often motivated by more than pure economics. Arcelor, headquartered in Luxembourg, has become the largest steel producer in the world as the result of the merger of several European firms. Its history is deeply intertwined with the history of the European Union itself, which originated in 1952 as the European Coal and Steel Community. When the French and Germans were still deeply suspicious of each other, Luxembourg came close to being neutral ground.

In most countries, no matter how completely the steel industry dominates its domestic market, it must still sell abroad in order to be profitable. The Japanese have become the largest exporters of steel in the world. The Koreans built their huge POSCO steel plant, considered the world's most efficient, directly at a seaport, making it simple and economical to get ore to its blast furnaces. That location, much more than the cost of labor, is an advantage which few American mills can overcome. With steel deemed so important by so many nations, the industry is threatened with a chronic state of oversupply.

It never escaped America's attention that so much foreign steel development was the result of direct or indirect government subsidy. Since 1980, according to a Department of Commerce publication "nearly 40% of unfair trade cases investigated in the United States have been related to steel products. More than half of these have resulted in some form of relief." Of course the American steel industry always viewed the relief as inadequate and even persuaded George Bush to institute protective tariffs, which the WTO, not surprisingly, ruled illegal. Steel, ever a powerful symbol in international trade, has now come to symbolize as well the asymmetrical nature of trade conflicts. Export subsidies are much harder to identify and oppose than are protective tariffs.

The Bush tariffs were wrongheaded, of course. They were simply another tax on American businesses and consumers and would have done more harm than good to our own economy. But unlike tariffs, the pros and cons of *subsidies* are more difficult to identify. Some opposed agricultural price

supports well before they became an issue at the recent WTO meeting in Cancun, but farming has long enjoyed a privileged position in this country for reasons that most Americans never even associate with foreign trade. And in truth, some subsidies really are motivated entirely by domestic considerations. Consider the history of the Internet. How long would its creation have been delayed if the Defense Department hadn't done the heavy lifting by establishing Arpanet in the 1960s? There are subsidies which trade organizations don't try to rule on because it is nearly impossible to do so.

Countries that have subsidized their own industries have indirectly subsidized the American consumer as well. The United States often chooses not to compete with those subsidies, choosing instead to invest in newer, more profitable industries. There has been a decisive comparative advantage in being early, but that advantage is becoming increasingly hard to maintain. However globalism is defined, it surely means that nations' economies are increasingly interdependent. Innovations get copied quickly, and foreign trade becomes a larger part of our GDP. The trade deficit may indicate something about our low rate of savings, but it is also telling us a lot about the rest of the world's competitiveness. The robust state of our banking system, together with the globalization of the financial markets, makes capital cheaper and more available, but globalism does not assure that investment opportunities will be greatest in the country that houses the biggest banks. By definition, globalism diminishes rather than increases home field advantage.

Not all neglect is benign

AMONG THOSE MAINSTREAM economists who profess to see no current threat in the trade deficit, are some more ambivalent than they care to admit? Eamonn Fingleton, who takes a decidedly nonmainstream view of foreign trade issues, wrote a piece in the *Atlantic Monthly* for which he interviewed 10 recent Nobel economists. Of them, only Gary Becker was, in Fingleton's words, "prepared to endorse the media and Wall Street view that deficits pose no policy problem for the United States." Interestingly, seven of the 10 laureates didn't want to speak on the record at all.

Maybe those economists just didn't want to talk at length with Fingleton, but another possibility is that they've discovered how difficult it is to comment seriously on the trade deficit without unintentionally handing ammunition to protectionists. This is a dilemma that, sooner or later, can confront any economist who firmly believes in free trade but also believes that national policy can be brought to bear on the trade deficit. Focusing political attention on trade issues too often results in laws like the Byrd Amendment, which directs U.S. Customs to distribute to injured domestic producers the

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duties collected as a result of antidumping orders. In effect, the Byrd Amendment turns American firms into bounty hunters. The provision was ruled illegal by the WTO, but a large Senate majority opposed its repeal.

Trying to avoid yet another pernicious trade law is understandable. But meanwhile the trade deficit is not diminishing and the strategy of benign neglect is not working. Many legislative actions, in fact, seem long overdue. America's international competitiveness could, for instance, be enhanced through reform of both tort and product liability law. But the broadest area of agreement in the trade deficit debate is that Americans' rate of savings must improve, so that seems a logical starting point for policy proposals, especially since, through tax reform, it is possible to promote savings and competitiveness at the same time.

Shifting some taxation away from savings and capital formation and toward consumption could have several favorable consequences. The United States' statutory corporate tax rates are higher than those of all of our major trading partners, with the exception of Japan. Meanwhile, many of our trading partners, who do have higher taxes on consumption — mostly in the form of a value-added tax — are permitted to rebate the VATs to foreign buyers because the WTO deems them "direct" taxes. On the other hand, the United States' attempts to level the playing field, using its own corporate tax adjustments, have consistently been ruled illegal as "indirect" taxes. The recently passed American Jobs Creation Act of 2004 is Congress's latest attempt to comply with WTO requirements. That bill did repeal the extraterritorial income tax exclusion, but it simultaneously enacted a hodgepodge of tax breaks, most of which are unlikely to have significant impact on foreign trade or American competitiveness.

Not that tax reform alone is the answer. But intelligent tax reform is a vehicle whereby free traders can raise the profile of the trade deficit without giving support to protectionists. In any event, the trade deficit and the rising external debt that has accompanied it deserve a higher place in the hierarchy of policy concerns than they now receive. The principle of free trade is strong and defensible, and it will not collapse under the weight of serious discussion of related issues.