Is Our Trade Deficit Sustainable?

A Systems Thinking Perspective on Trade

By Robert Powell Ph.D

How can there be so much disagreement about what's called "free trade?" While both sides have logical arguments, they bypass each other.

The reason: One side is logical from the perspective of the individual firm and the other is logical from the perspective of all businesses taken as a whole. This happens because offshoring is subject to the "fallacy of composition," where individually logical decisions are collectively irrational.

Trends in Trade

Even proponents of current U.S. trade policy profess at least public concern about what's happening. The black bars in Figure 1 show the history of China's growing trade surplus with the U.S. through 2002. A chart showing this trend in a 9/02/03 New York Times article stated: "U.S. Treasury Secretary John W. Snow will meet this week with Chinese officials in hopes of curbing China's growing trade surplus."

How did that meeting work out? It didn't; the deficit rises unabated. (See red bars)

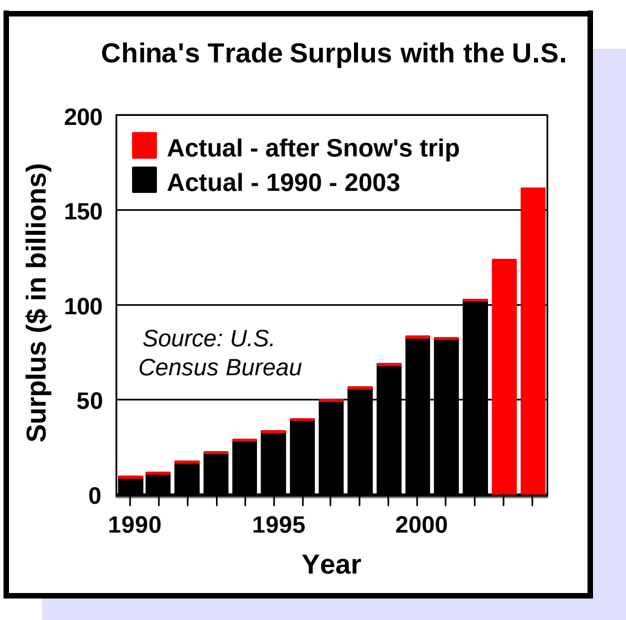

Figure 1. China's rising trade surplus with the U.S.

Figure 2 shows the overall U.S. trade deficit. Projecting along the current exponential trend, the deficit will be 10% of GDP by 2007. The cumulative trade deficit (or debt) is now 40% of GDP; the projection is 100% in 2010.

That's a lot of borrowing. It's a serious concern too, because no exponential increase persists forever. The trade deficit will stop growing, perhaps very abruptly, when other nations stop accepting U.S. dollars for their goods.

So why aren't more people concerned? Perhaps it's because they are being perfectly rational, but falling prey to the "fallacy of composition."

Fallacy of Composition

In daily life, how does this fallacy occur? Let's look at these examples:

Individually logical actions can be collectively irrational.

Sports Spectators – A spectator who can't see may stand to improve his view. When he does, his view improves but now he blocks the view of others. To see better, they also stand. When everyone's standing, no one has a better view than they did before. And standing takes more energy, so the act of everyone standing is less efficient. In systems thinking this is a "fix that fails."

Ocean Fishing – To increase profits, every fisherman puts out more boats. As the catch increases, it brings additional profits to fund even more boats. Unfortunately, as total fishing approaches the sustainable ocean capacity, the effort required per fish caught increases, which now reduces profits. In systems thinking this "tragedy of the commons" is particularly perverse because the scarcity created drives up prices, sending exactly the wrong signal to preserve the resource.

Offshoring – Because the world economy has a great offshore labor supply compared to demand, offshore

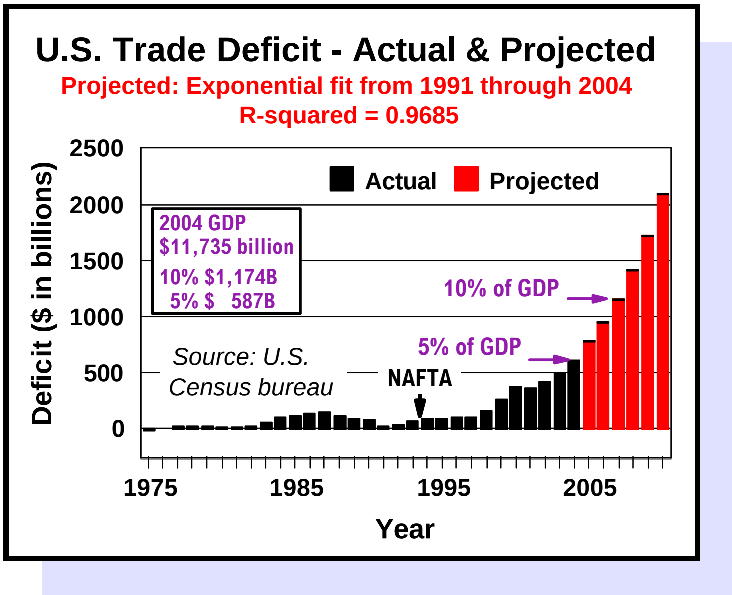

Figure 2. The rising U.S. trade deficit.

wages remain very low. U.S. corporations have found they can reduce costs and increase profits by tapping this low-cost offshore labor. However as more companies use offshore labor, it causes extreme price competition between those players. Therefore, as a consequence, downward pressure is forced on corporate profits. If only one company does this, it works. But when all do, none have lower costs than others. When it comes to competition, they're no better off than they were before.

Then too, the severe wage competition reduces U.S. wages, shrinking U.S. purchasing power and U.S. market demand. This further increases U.S. price competition and creates pressure for even more offshoring. As long as offshore pay is low and there's a global glut of capacity, this "reinforcing feedback" will continue to power offshoring and our exponentially-increasing trade deficit.

Systems Thinking: Seeking to understand system behavior by examining "the whole," instead of by analyzing the parts.

So the "fallacy of composition" catch is that, though we get less expensive goods, U.S. purchasing power erodes, undermining the whole economy. Plus, China's demand has driven up oil, steel and other commodity prices to the extent that in the U.S. we're now paying in other ways for those cheaper goods.

Some argue that eventually demand for offshore labor will increase and raise offshore wages. True, but unfortunately there'll be a long delay before demand exceeds supply, keeping offshore wages low for many decades in the future. And even then, the world equilibrium of pay would be at the weighted mean between U.S. and China pay. With so many Chinese workers, that very low pay won't pay a U.S. home mortgage.

Another counter argument is that, as economic conditions improve and offshore and pay rises, the world will purchase more goods from the U.S. However, as long as price is an issue, they'll also purchase from offshore low-cost sources.

It's likely that, long before reaching equilibrium, the exponentially-increasing trade deficit will cause the rest of the world to stop taking U.S. dollars for their goods. The Federal Reserve response will be to raise interest rates to maintain borrowing. This will seriously depress, and likely collapse, the U.S. economy.

Conclusions

1. U.S. offshoring is subject to the "fallacy of composition" where individually logical decisions can be collectively irrational.

2. Exponential increases in anything, including the trade deficit, are unsustainable.

3. The reinforcing feedback that drives offshoring will continue as long as there is a global glut of supply relative to demand and there are large U.S. versus offshore wage disparities.

Exponential growth is slow at first. Many trade proponents still suffer from the "boiled frog" syndrome. As the trade deficit growth rate continues to increase, more will recognize the problem and "jump out of the pot."

Nations don't "trade;" individuals and companies do. It's not an individual business's job to look out for the good of the nation as a whole. …. That's government's job. It's not doing it.