

# **Impacts of the Trade Deficit on the U.S. Economy**

Briefing for the  
Trade Deficit Review Commission

**September 9, 1999**

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Dr. Weidenbaum and members of the Commission, thank you for inviting me here to brief you on the impacts of large and chronic trade deficits on the American economy. This afternoon I will discuss the consequences of the steady growth in the U.S. trade deficit for workers in the U.S., and in other countries, as well.

### *Trade Deficits Injure Workers in Many Ways*

The growth in structural trade deficits in the U.S. since the 1970s has eliminated millions of jobs, most of them concentrated in high-tech, high-wage manufacturing industries. In addition, the growth in trade with low-wage countries, which are also responsible for a large share of the U.S. trade deficit, has had tremendous depressing effect on wages in manufacturing and other sectors of the economy, through a number of channels that are discussed below.

Surprisingly, U.S. trade deficits have not been good for workers in developing countries, either. Recent research has revealed that globalization is associated with rising levels of income inequality in many countries, and the recent Mexican, Asian, Brazilian and Russian financial crises have shown that increased openness may have increased macroeconomic instability, as well.<sup>1</sup> I will briefly review this evidence because it is important to establish that globalization confronts workers in poorer nations with many of the same problems facing their counterparts here in the U.S. Hence, the solutions to these problems must also be global in nature.

### *Trade Deficits and Employment*

Proponents of recent trade initiatives have consistently used misleading job numbers to support their case. For example, the Clinton Administration claimed in 1997 that 2.3 million jobs in the United States were supported by exports to Mexico and Canada, 311,000 of them attributable to increased trade under the North American Free Trade Agreement (NAFTA). It also claims that rising exports to NAFTA countries have created jobs in every state in the Union (EOP 1997).

Discussions of trade, however, must consider imports as well as exports. Ignoring the impact of imports is like trying to keep score in a baseball game by counting only the runs scored by the home team. If the United States exports 1,000 cars to Mexico, many American workers are employed in their production. If, however, the U.S. imports 1,000 cars from Mexico rather than building them domestically, then a similar number of Americans who would have otherwise been employed in the auto industry will have to find other work.

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<sup>1</sup> The growing frequency of financial crises suggests that capital market liberalization and the rapid growth of international capital flows (especially short-run capital) may have increased the variance of income in many developing countries. See Jason Furman and Joseph E. Stiglitz "Economic Crises: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity, Macroeconomics*, 2:98.

If Chrysler builds a new factory in Mexico to assemble trucks, then closes a similar plant in the U.S., and exports all the parts used in that plant to Mexico, then U.S. exports will increase. In the administration's approach, all those parts will be counted as "new exports," which contribute to job creation. A "multiplier" is then applied to those exports to determine the number of jobs created.<sup>2</sup>

The only accurate way to measure the impact of the globalization of vehicle production is to examine its *net* impact on trade, by considering the impacts of changing flows of both exports and imports. The expansion of exports creates jobs and the growth of imports eliminates domestic employment. In the Chrysler example, if the trucks assembled in Mexico are re-exported to the U.S., then the U.S. trade deficit will increase, resulting in a net loss of jobs in this country.

EPI has prepared a number of detailed studies in the past several years which show that the growth in the trade deficit over the past two decades has destroyed millions of high-wage, high skilled manufacturing jobs in the U.S. When the economy is at full-employment, and in the long run, workers whose jobs have been eliminated by the trade deficit will find jobs in industries producing non-traded goods. Thus, trade deficits are responsible for a change in the *composition* of employment, but are unlikely to cause a rise in the *level or rate* of unemployment, in the long run, even though large numbers of jobs have been destroyed.

Recent and prospective job losses due to rising trade deficits are summarized in **Figure 1**. Between 1979 and 1994, the growing trade deficit eliminated 2.4 million jobs in the U.S. (Scott, Lee and Schmitt 1997). Almost all of these jobs were concentrated in the manufacturing sector.

After NAFTA was implemented, on January 1, 1994, the U.S. trade surplus with Mexico turned into a deficit. Rothstein and Scott (1997a) showed that between 1994 and 1996, changes in trade with the NAFTA countries eliminated an additional 395,000 jobs, as shown in Figure 1. Growing trade deficits with China (not shown) also eliminated several hundred thousand jobs in this period (Rothstein and Scott 1997b).

Since 1997, the Asian financial crisis has greatly increased the U.S. trade deficit. At the beginning of that crisis EPI forecast that it would eliminate up to two million jobs in the U.S., with most of the losses concentrated in the manufacturing sectors of the economy (Scott and Rothstein 1998). These job losses have begun to materialize, despite the continuing boom in the rest of the economy. The U.S. has lost nearly 500,000 manufacturing jobs since March of 1998, due to the impact of the rising trade deficit.<sup>3</sup>

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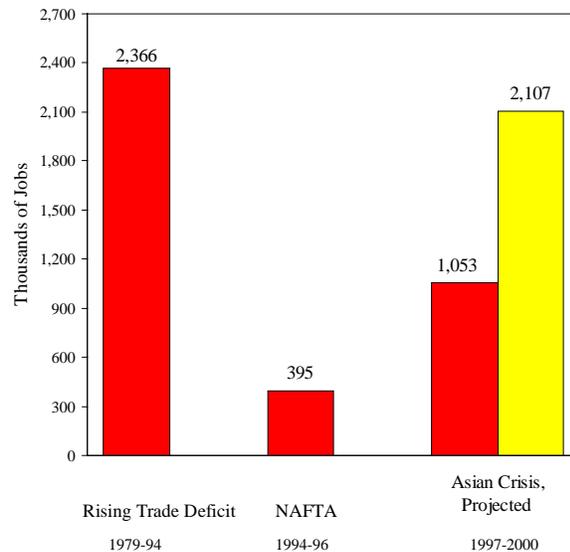
<sup>2</sup> Current estimates suggest that \$1 billion in exports generates about 13,000 job opportunities in the U.S., on average (Rothstein and Scott 1997a).

<sup>3</sup> For changes in manufacturing employment, see the U.S. Bureau of Labor Statistics homepage: <http://stats.bls.gov/>.

The IMF recently forecast that the U.S. current account deficit (the broadest measure of the trade balance) would reach nearly \$300 billion in 1999, exceeding 3.5 percent of GDP for the first time in the post-war era (IMF 1999). The U.S. can expect to lose another 400,000 to 500,000 manufacturing jobs as a result, even if the economy continues to expand at its current pace in 1999.

**Figure 1**

**Jobs Lost Due to Trade,  
1979-2000**



Source: Economic Policy Institute

In sum, trade has eliminated more than three million U.S. jobs in goods producing industries in the past two decades. Many more will be lost in the future unless the long-term growth in the U.S. trade deficit is halted. The expansion of output in other sectors of the economy has been sufficient to absorb most workers dislocated by trade, in the past. However, trade-related job loss has become a lightning rod for public discontent about the consequences of globalization for several reasons, in addition to the direct costs of job loss. Trade and globalization are associated with an increase in the insecurity of workers, particularly in industries subject to foreign competition. In addition, trade deficits are directly linked to falling wages for non-college-educated production workers, and to recent increases in the inequality of income distribution in the U.S.

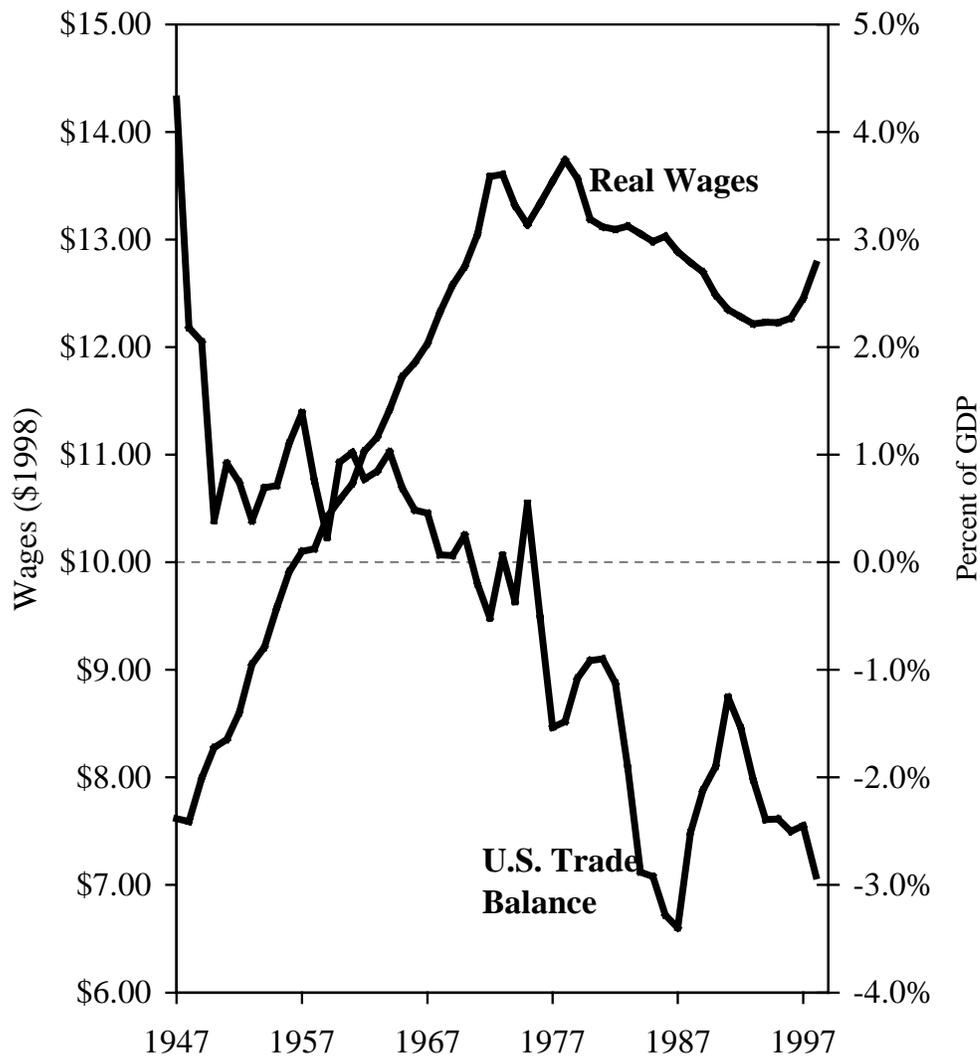
## Trade and Wages

In the 1950s and 1960s, the U.S. was the world's leading export powerhouse. The Marshall plan helped provided the capital needed to rebuild Europe and Japan, and fueled a tremendous demand for U.S. exports.

During this period, the U.S. ran a substantial trade surplus, of about one percent of Gross Domestic Product, as shown in **Figure 2**. The U.S. also benefited initially from strong export demand in a wide range of industries, from low-tech textiles and apparel to sophisticated aircraft and machine tools.

**Figure 2**

### Real Wages and the U.S. Trade Deficit, 1947 to 1998



Since the 1970s the U.S. moved from a trade surplus to a deficit position, as Europe and Japan began to compete effectively with the U.S. in a range of industries. The trade surplus of the 1960s was transformed into a deficit that reached 2.9% of GDP in 1998, as shown in Figure 2. This deficit will grow rapidly in the future as a result of the continuing global financial crisis.

Trade deficits also have a direct impact on wages, especially for non-college educated workers, who make up three-quarters of the U.S. labor force. The other line in Figure 2 shows that the average real wage for U.S. production workers peaked in 1978, declining more or less steadily through 1996. Real wages have begun to increase in the past 3 years. However, the small upturn increased real wages by only 4.5%, not nearly enough to offset a decline of more than 11% since the 1978, nor to return workers to the path of steadily rising wages they experienced from 1950 through 1973.

What is responsible for the decline in U.S. wages? Trade is certainly one of the most significant causes, because it hurts workers in at least six different ways.<sup>4</sup> Trade deficits represent the leading edge of the broader effects of trade on U.S. wages. They reflect the cumulative impact of the unfair trade practices and poor U.S. macroeconomic policies discussed at your last briefing, on August 19, by Dr. Blecker.

First, the steady growth in our trade deficits over the past two decades has eliminated millions of U.S. manufacturing jobs. Most displaced workers usually find jobs in other sectors such as restaurants and health service industries, where wages are much lower, as shown above. Thus trade deficits directly reduce average wage rates.

Second, imports of intermediate manufactured goods (used as inputs in the production of final goods) also help to lower domestic manufacturing employment, especially for production workers and others with less than a college education. The expansion of export “platforms” in low-wage countries has induced many U.S. manufacturing firms to outsource part of their production processes to low-wage countries. Since firms generally find it most profitable to outsource the most labor-intensive processes, the increase in outsourcing has hit non-college-educated production workers hardest.

Third, low wages and greater world capacity for producing manufactured goods can lower the prices of many international goods. Since workers’ pay is tied to the value of the goods they produce, lower international prices can lead to a reduction in the earnings of U.S. workers, even if imports themselves do not increase.

Fourth, in many cases the mere threat of direct foreign competition or of the relocation of part or all of a production facility can lead workers to grant wage concessions to their employers.

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<sup>4</sup> See Schmitt (1999) and Mishel, Bernstein and Schmitt (1999, 175-182) for a review of the evidence for each of the factors discussed in this section.

Fifth, the very large increases in direct investment (i.e., plant and equipment) flows to other countries have meant reduced investment in the domestic manufacturing base and significant growth in the foreign manufacturing capacity capable of competing directly with U.S.-based manufacturers.

Finally, the effects of globalization go beyond those workers exposed directly to foreign competition. As trade drives workers out of manufacturing and into lower-paying service jobs, not only do their own wages fall, but the new supply of workers to the service sector (from displaced workers plus young workers not able to find manufacturing jobs) also helps to lower the wages of those already employed in service jobs.

Most economists now acknowledge that trade is responsible for 20 to 25 percent of the increase in income inequality which has occurred in the U.S. over the past two decades. However, existing research can only explain about half of the change in income inequality. Therefore, trade is responsible for about 40% of the *explainable* share of increased income inequality. The rest is due to forces such as declining unionization, and inflation-induced erosion in the value of the minimum wage.

#### *Globalization and Incomes in Developing Countries*

In its 1997 *Trade and Development Report*, the UN Commission on Trade and Development (UNCTAD) reviews some very important data showing that globalization has also been associated with rapidly growing income inequality in many developing countries.<sup>5</sup> This report notes that globalization of international trade and finance can affect incomes in the South through at least two primary channels. First, increased access to international capital flows should reduce profits rates in the South (since capital is in scarce supply in developing countries), and thereby improve the labor share of national income. However, the growth in trade flows in high-technology products that involve high levels of knowledge and skills content can also increase the premium earned by skilled workers, relative to less skilled labor. Thus unskilled workers can either gain or lose from globalization, depending on the relative importance of these two factors.

UNCTAD (1997, 135) finds that countries that have engaged in rapid, unilateral reductions of barriers to imports have experienced a significant widening in income inequality. Latin America, in particular, has gone much further than East Asia in reducing trade barriers. The report reviews a number of studies of trade liberalization in Argentina, Chile, Columbia, Costa Rica, Mexico and Uruguay, and found:

almost unanimous evidence of rising rather than falling wage differentials. In most countries the wage gap widened while the real wages of unskilled workers

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<sup>5</sup>For reviews of the economics literature on trade and wages, see Lee, Thea. 1997. "Trade and Inequality." In Ray Marshall, ed., *Restoring Broadly Shared Prosperity*. (Washington, D.C.: The Economic Policy Institute), and Burtless, Gary. 1995. "International Trade and the Rise in Earnings Inequality." *Journal of Economic Literature*, Vol. 33, June.

actually fell and unemployment increased. ... [While] other factors... including those linked to macroeconomic adjustment and labour market reform ... may have contributed to increased wage inequality in some countries, it is explained primarily by trade liberalization.

UNCTAD also cites a report from the Economic Commission on Latin America (ECLAC 1997, 60), which found that in Latin America:<sup>6</sup>

The distance separating the incomes of professional and technical personnel from those of workers in low-productivity sectors increased by between 40 per cent and 60 per cent in 1990-94. This was due to the rapid improvement of labour incomes of skilled manpower and the reduction or lack of growth in pay levels for workers not taking part in the modernization of production, who account for a large percentage of total employment.

It is important to note that in most developing countries so-called “unskilled” or production workers make up the vast majority, often more than 90%, of the labor force.

These findings contrast sharply with those of Adrian Wood, who provides qualified support for the proposition that “export oriented industrialization...reduces inequality within developing countries” (Wood 1994, 13).<sup>7</sup> Wood’s analysis is based, in part, on an examination of wage growth in the East Asian economies. However, as the UNCTAD report points out, those economies have combined export promotion with import protection, and tariffs in Latin America are now significantly lower than in East Asia. UNCTAD concludes that manpower policies (training and education) combined with carefully managed industrial upgrading (through application of industrial policies) were key ingredients in East Asian development strategies that increased skilled labor supplies and helped prevent an increase in skills differentials and wage inequality (UNCTAD 1997, 124).

Thus, there is an emerging consensus in the economics profession and the development community that globalization, as experienced under recent patterns of globalization, has increased income inequality in both the North and the South.<sup>8</sup> In

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<sup>6</sup>ECLAC. 1997. *The Equity Gap: Latin America, The Caribbean and the Social Summit*. (LG/G,1954. (CONF86/3)), Santiago, Chile. March.

<sup>7</sup>Wood, Adrian. 1994. *North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World*. Oxford: Clarendon Press. Wood’s qualifications concern the distinction between literate and illiterate workers. He argues that globalization has increased the gap between these groups, and hence inequality. However, he also points out that there are comparatively few illiterates in the countries that are exporting products to the North, “[s]o the reduction in inequality should have predominated.” (Wood 1997, 14).

<sup>8</sup>Although there is some remaining debate among economists about whether or not trade has increased income inequality in the U.S., even earlier skeptics such as Robert Z. Lawrence now acknowledge that trade has had a small but negative and significant effect on U.S. income distribution. See John Schmitt and Lawrence Mishel. 1996. “Did Trade Lower Less-Skilled Wages During the 1980s? Standard Trade Theory and Evidence.” Washington D.C.: Economic Policy Institute, Technical Paper. July. See also, Schmitt 1999.

addition, data and analysis reviewed here suggest that it may also have reduced real incomes for production workers in many countries.

### *Conclusions*

Globalization is not a zero-sum game. For most working families in the developed and developing world, it has been a negative sum game for at least the past two decades. For the U.S., in particular, falling production worker incomes are a reversal in a long-run trend of rising living standards and broadly shared prosperity that dates back to the end of the Second World War.

These results suggest that it is not trade liberalization, *per se*, that have caused the U.S. trade deficit and related increases in income inequality. Rather, it is the particular path of trade liberalization that we have followed. That path has created a deregulated global economy in which multinational corporations are free to pit workers in the North and the South in a bidding war in which both lose.

The solution to this dilemma is not to close off trade. Rather, it must involve the creation of new types of regulations to prevent self-destructive behavior on the part of market participants. While policy matters are not the subject of your discussions today, I would encourage you to consider a full range of policy alternatives to reduce the U.S. trade deficit and raise production worker incomes in the North and the South.

New policies should be developed to improve the enforcement of labor rights in developed and developing countries, in order to encourage rising wages for all production workers. You should also consider measures to reverse the accumulation of global excess production capacity in a range of industries from steel to autos and computer chips, and the destructive forms of competition from which it results. And finally, you should propose a full menu of policy options for attacking other root causes of the structural trade deficit, including systematic discrimination against U.S. exports through non-tariff barriers to trade that persist in the economies of many of our trading partners. The trade deficit threatens to pull the U.S. economy into the deepest recession since the 1930s, and could destabilize the global economy in the not too distant future if it is not reduced or eliminated.

Thank you. I'd be happy to answer your questions at this point.

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<sup>9</sup> Most EPI papers can be obtained from the EPI homepage: [epinet.org](http://epinet.org), or by calling the number listed on the cover of this statement (a duplication fee is charged for printed copies of reports).