

Statement at Hearings before the U.S. Trade Deficit Commission

by Milton Friedman

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I am pleased to have an opportunity to testify on the causes and consequences of trade deficits .

The world is currently experiencing the effects of two major revolutions of the past few decades: a technological revolution that is transforming the way the world does business, and a political revolution sparked by the fall of the Berlin Wall in 1989 and the Deng reforms in China starting in 1977.

The technological revolution in computers, telecommunications, and related industries has made it possible for an enterprise to be located almost anywhere in the world, produce goods and services almost anywhere in the world, and distribute its products almost anywhere in the world. As that possibility unfolds it will greatly strengthen and widen the existing global economy. The political revolution reinforces the effect of the technological revolution, by greatly expanding the supply of low-cost yet not low-quality labor available to the global economy, discrediting central planning, and raising the appeal of market mechanisms.

Taken together, these two revolutions offer the opportunity of a major economic revolution comparable to the industrial revolution that started 200 years ago. The industrial revolution produced a greater increase in world output in the past 200 years than in the preceding two thousand. The information revolution under way has the potential of repeating that remarkable achievement.

We are now seeing the first stages of the major restructuring of worldwide production and trade that will be produced by the information revolution. .Capital-intensive activities--human capital as well as physical capital-- are moving to the center of the technological revolution, so far largely in the United States but soon to include Europe and Japan -- and labor-intensive activities are moving to underdeveloped countries, including the former Soviet satellites in East Europe,as well as China, and India. Free trade in goods, services, and capital is by far the most effective way to expedite a worldwide transformation that promises a major improvement in human well-being around the world.

In the process, deficits and surpluses in balances of payments are unavoidable. The countries to which capital is moving will have balance of payments deficits — the opposite face of a capital surplus — financed by countries whose internal savings are larger than can be absorbed in domestic activities that yield a competitive rate of return. Such deficits, far from being a burden, are an essential ingredient in the adjustment process. The remarkable performance of the U. S. economy in the past few years would have been impossible without the inflow of foreign capital -- the mirror image of large balance of payments deficits.

California is a splendid example. If balance of payments figures were available for California alone, they would show that California has experienced a steady stream of deficits for decades on end just as the U.S. on a whole did in the last half of the nineteenth century. California has grown far more rapidly than most of the rest of the country. If California enterprises had been forced to rely on the savings of California citizens alone, it could never have financed its rapid growth. That was possible because capital was moving from the East to the West to benefit from the higher rates of return that were attainable in California. It was possible because California was experiencing large and continuous balance of payments deficits.

Ignorance is sometimes bliss. Imagine the public reaction if the *Los Angeles Times* and the *San Francisco Chronicle* were to come out with headlines reading 'California Faces a Multibillion Deficit in Payments to Rest of Country.' Could Sacramento have refused to respond in some way?

As an empirical economist, I very much welcome detailed government statistics on almost anything including international trade, yet as a political economist and citizen, I often sympathize with my old teacher at the University of Chicago, Lloyd Mints, who contended that U.S. trade policy would be far better if, like California, the U.S. had no such data.

Given that we do have such data and are likely to have more rather than less, the only alternative is to try to educate the public on the merits of free trade in goods, in services, and in capital. Your commission will, I am sure, make an important contribution to that objective.,