Mitchell's Musings 3-23-15: Understand the Implications

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Below is an excerpt from the transcript of a recent (March 18, 2015) National Public Radio (NPR) broadcast:

> *DON GONYEA, HOST:*
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> *Call it one of those conflicts that happen among friends - in this case, Democrats and labor unions. The sore spot is trade and the Obama administration's push for authority to negotiate a big, new trade deal covering the Pacific region. Unions want to stop it. At a speech in Washington today, AFL-CIO President Richard Trumka said history shows such deals have hurt the little guy…*
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> *GONYEA: Trumka and labor are clearly already looking ahead to next year's elections including the presidential race. Joining us to talk about all of this is longtime labor journalist Steven Greenhouse. Steve, hello…*
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> *GREENHOUSE: …The Obama administration, like the Clinton administration, think trade deals are great. They help bring in cheaper foreign goods that help American consumers. They create investment opportunities for American companies. And they say, look, labor, manufacturing jobs are going to go overseas anyway because labor costs are cheaper in Mexico or China, and it's not trade deals that are doing it. You know, labor unions say no, these trade agreements really accelerate this, and we don't like it, and we want to slow it and maybe stop it…*

Source: http://www.npr.org/2015/03/18/393870615/trade-policy-vote-could-affect-organized-labors-role-in-2016-election

Perhaps you heard the broadcast. The bulk of the interview consists of the political angle, i.e., a threat by organized labor to withhold campaign funding for Democrats who support the trade agreement. Neither the host nor the guest commented on the premise attributed to both the Clinton and Obama administrations that "manufacturing jobs are going to go overseas anyway because labor costs are cheaper in Mexico or China, and it's not trade deals that are doing it." So let's unpack the premise.

There are really three elements in the premise: 1) manufacturing jobs are going overseas, 2) the job loss in manufacturing isn't due to trade deals, and 3) the job loss is due to lower labor costs abroad.

We have noted in previous musings that manufacturing jobs have been in long-term decline, although – after a dive in manufacturing employment resulting from the Great Recession – there is some cyclical recovery. So let's just say that point #1 is not controversial. That conclusion leaves points #2 and #3.

You probably have noted that there are many Japanese and German cars on the road. Neither country features cheap factory labor. So you should at least be somewhat suspicious about #3. On the other hand, we haven't really had any big trade deals involving Japan and Germany for a long time so you might have a sense that #2 is plausible. But if it isn't trade deals or #3 that is causing #1, then there must be some other causal elements at work. Let's note some statistical facts about U.S. foreign trade in manufactures. Although there are various industrial classifications used for defining trade in "manufacturing," here are some numbers to keep in mind.

- In 2014, using the SITC statistical division, about three fourths of U.S. goods exports were manufactures. In that same year, about 80% of U.S. goods imports were manufactures.[1]
- In 2014, about three fourths of exports of goods and services consisted of just goods. In that same year, over 80% of U.S. goods and services imports were just goods.[2]

Those two facts suggest that if there were *increases* in U.S. exports of goods and services, surely U.S. manufacturing exports would have to rise. If everything stayed proportional, a billion dollars of increased exports would entail something like half a billion dollars' worth of manufacturing exports. ($1 billion x .75 x.75 = $563 million.) Similarly, a billion dollar *decline* in U.S. imports of goods and services would entail about $600 million decline in manufacturing imports. ($1 billion x .8 x .75 = $600 million.)

Using these approximate ratios, what would happen if the U.S. net export balance on goods and services, instead of having been around -$500 billion in 2014 had been zero (so that U.S. indebtedness to the world would stop increasing)? One way to close the gap between exports and imports would be to raise exports by about 15% and cut imports by about 10%. Exports and imports of goods and services in that case would have been about $2.5 trillion each. Again, just assuming simple proportionality would imply that there would be a net increase in U.S. domestic manufacturing (more production for manufacturing exporting and more production to make up for the drop in foreign manufacturing imports) of something around $300 billion. Bumping up net foreign demand for U.S. manufactures by that amount would raise economic activity in the manufacturing sector by around 15%.

You can play with these assumptions any way you like. Obviously, simple proportionality is only one possible assumption. But no matter what you can reasonably assume, manufacturing can't simply "go away" if the net export balance is ever to improve, at least from negative to zero. The only way to stop American indebtedness to the world from increasing is to achieve at least a zero net export balance. The only way to start *paying down* U.S. net indebtedness to the world is to run a net export *surplus* – which would require an even bigger step up in U.S. manufacturing.

When you put the idea of manufacturing "going away" in that perspective, you have to have a plausible scenario under which the U.S. manufacturing sector disappears because the U.S. simply borrows the money from the rest of the world need to finance its absorption of manufactured goods. U.S. debt to the world grows forever and never has to be repaid under that scenario. Alternatively, if you think the borrowing at some point must at least halt, if not reverse, while at the same time manufacturing "goes

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[1] https://www.census.gov/foreign-trade/Press-Release/2014pr/12/exh15.xls. SITC = Standard International Trade Classification.

[2] https://www.census.gov/foreign-trade/Press-Release/2014pr/12/ft900.pdf.

away," you have to believe that the U.S. pays for its absorption from abroad of manufactures and other goods and services by exporting something other than manufactures. What might those other exports be? Movie royalties? Tourist services? Fees from patent licensing? Rice? Coal? What?

Although the numbers bounce around due to exchange rate variation and the market valuations of particular assets and liabilities, the U.S. net international position (assets minus liabilities) stood at around -$2 trillion in the years leading up to the Great Recession. The most recent estimate (for the third quarter of 2014) is over -$6 trillion.[3] That's a big jump for a period of about a decade.

Now let's go back to the unquestioned premise contained in the NPR broadcast with which we started this musing. Is it some trade agreement that is behind the net export deficit and growing U.S. international debt? Trade agreements typically lower barriers to trade (tariffs, quotas, other regulatory limits on trade) in *both* directions. If they increase imports, they should also increase exports, other things equal. But is there an influence - outside of trade agreements - that tends to increase one and decrease the other?

Think about the exchange rate. An increase in the value of the dollar relative to other currencies discourages exports and encourages imports. Put another way, if the U.S. dollar's value relative to other currencies is "too high," there will tend to be a net export deficit. To sustain such a deficit, someone has to accept more and more net borrowing by the U.S. Foreign central banks – for reasons internal to their national polities - can always stand by to absorb excess U.S. net debt if the private sector won't do it.[4]

We have discussed what might be done about the dollar exchange rate in previous musings. But the bottom line for this musing is that you can't talk about manufacturing "going away" (and about the possible role of trade agreements in its assumed demise) without at least discussing the exchange rate issue. Once you start looking at the exchange rate issue, it will become clear that whatever other objections you have to particular features of trade agreements, such agreements are not the basic element that is – as the NPR broadcast put it - "hurting the little guy."

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[3] http://www.bea.gov/international/bp_web/tb_download_type_modern.cfm?list=2&RowID=144 and http://www.bea.gov/newsreleases/international/intinv/2014/pdf/intinv314.pdf.

[4] At one time, the U.S. Bureau of Economic Analysis in its balance of payments and international position tables readily made available "foreign official assets in the U.S." which allowed tracking of the accumulation of dollar holdings by foreign central banks. It showed a burst in such activity starting with the Great Recession. That series has been discontinued, a decision that should bother someone. See http://research.stlouisfed.org/fred2/series/BOPIOGT.